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[JOINT COMMITTEE PRINT]

PROPOSAL RELATING TO CURRENT U.S. TAXATION OF CERTAIN OPERATIONS OF CONTROLLED FOREIGN CORPORATIONS (H.R. 2889—AMERICAN JOBS AND MANUFACTURING PRESERVATION ACT OF 1991) AND RELATED ISSUES

SCHEDULED FOR A HEARING

BEFORE THE

HOUSE COMMITTEE ON WAYS AND MEANS

ON

OCTOBER 3, 1991

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

OCTOBER 1, 1991

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INTRODUCTION

The House Committee on Ways and Means has scheduled a public hearing on October 3, 1991, on H.R. 2889 ("American Jobs and Manufacturing Preservation Act of 1991") [1] and related issues (such as proposals to provide an election for certain controlled foreign corporations to be treated as domestic corporations).

This pamphlet,[2] prepared by the staff of the Joint Committee on Taxation, provides background information, a description of present-law tax rules, a description of H.R. 2889 and some prior, unenacted proposals dealing with related issues, and an analysis of issues relating to H.R. 2889 and the U.S. corporate election proposal.

Part I of the pamphlet is a summary. Part II presents background data on foreign affiliates of U.S. corporations. Part III provides a brief discussion of the characteristics of some foreign tax laws, and a description of current U.S. tax rules affecting outbound investment that are relevant to the proposal. Part IV describes H.R. 2889, and it gives some history of prior, unenacted proposals dealing with closely related issues. Part V is an analysis of issues related to H.R. 2889 and the U.S. corporate election proposal. The Appendix provides explanatory notes relating to Table 1 in Part II.

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[1] H.R. 2889 was introduced on July 15, 1991, by Congressmen Dorgan and Obey.

[2] This pamphlet may be cited as follows: Joint Committee on Taxation, *Proposal Relating to Current U.S. Taxation of Certain Operations of Controlled Foreign Corporations (H.R. 2889—American Jobs and Manufacturing Preservation Act of 1991) and Related Issues* (JCS–15–91), October 1, 1991.

I. SUMMARY

Under present law, foreign income that U.S. taxpayers earn through controlled foreign corporations is not generally subject to U.S. tax until that income is repatriated to the United States. That is, such income enjoys U.S. tax deferral. Exceptions to deferral exist, but generally only for certain types of tax haven income and movable income. Manufacturing income, and income from some other types of business operations, on the other hand, typically enjoy the benefits of deferral. H.R. 2889 would expand present-law exceptions to deferral by imposing current U.S. taxation on income of controlled foreign corporations from imports into the United States.

Proponents could argue that the proposal neutralizes any tax advantages of locating production abroad rather than in the United States. Opponents could argue that the deferral provided by present law should not be denied to income derived from importing into the United States, because that deferral is necessary to enable domestically owned foreign operations to compete with their foreign-owned counterparts.

II. BACKGROUND DATA

Summary of activities of foreign affiliates of U.S. multinational corporations

According to Commerce Department data, in 1988 there were nearly 17,000 affiliates of U.S. multinational corporations located in over 130 countries.[3] These affiliates generated net income of $77 billion on $1.2 trillion of sales and held $1.2 trillion in total assets. In addition, foreign affiliates of U.S. corporations employed 6.4 million workers and paid $151 billion in employee compensation.[4] In that same year, while capital expenditures on domestic plant and equipment were $488 billion, majority-owned foreign affiliates of U.S. multinational corporations had capital expenditures of $43 billion.[5]

Activities of foreign affiliates by location

Nearly one-half of the $1.2 trillion of foreign affiliates' total assets were held by affiliates located in Europe, and most of these were located in the 12 countries comprising the European Communities. Of the remaining amount, 15 percent were held by affiliates located in Canada, 13 percent were held by affiliates located in Latin America, and 11 percent were held by affiliates located in Japan.[6] When measured in terms of employment, the presence of foreign affiliates of U.S. multinationals in the Western Hemisphere is greater than when measured in terms of total assets. Of total foreign affiliate employment of 6.4 million, 41 percent was by foreign affiliates of U.S. multinationals in Europe, 6 percent was be foreign affiliates in Japan, 15 percent was by foreign affiliates in Canada, and 20 percent was by foreign affiliates in Latin America.[7]

In general, the labor intensity in developing countries was greater than in developed countries. For example, for foreign affiliates engaged in manufacturing in developed countries, there were ap-

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[3] In the Commerce Department data, country classification is based on the location of the affiliate's physical assets or where its primary activity is carried out. This may not be the same as the country of incorporation. If an affiliate has physical assets or operations in two countries, it is considered two separate affiliates. In the Commerce Department data, both incorporated affiliates ("subsidiaries") and unincorporated affiliates ("branches") are included in the data. (This is in contrast to tax return data on foreign affiliates, presented below, which are classified by country of incorporation and include only corporations.) The information is from data for nonbank foreign affiliates of nonbank U.S. parents. Methodological issues in the Commerce Department data more fully are discussed in U.S. Department of Commerce, Bureau of Economic Analysis, *U.S. Direct Investment Abroad, 1982 Benchmark Survey Data*, Washington D.C., December 1985.

[4] U.S. Department of Commerce, Bureau of Economic Analysis, *U.S. Direct Investment Abroad, Operations of U.S. Parent Companies and their Affiliates, Revised 1988 Estimates*, July, 1991, Table 1. Unless otherwise noted, all data in this section are from this Commerce Department report (hereinafter referred to as "Commerce Department"). Data for years after 1988 are not yet available.

[5] Raymond J. Mataloni, "Capital Expenditures by Majority-Owned Foreign Affiliates of U.S. Companies," *Survey of Current Business*, Department of Commerce, March 1990, pp. 21-32.

[6] Commerce Department, Table 3.

[7] Commerce Department, Table 11.

proximately $138,000 of assets per worker and $238,000 in sales per worker. For foreign affiliates engaged in manufacturing in developing countries, there were approximately $57,000 of assets per worker and $74,000 in sales per worker.[8]

Activities of foreign affiliates by industry

Manufacturing accounted for 38 percent of total assets of foreign affiliates of U.S. corporations. Finance affiliates (excluding banks, as noted above) accounted for 29 percent, petroleum affiliates accounted for 16 percent, and wholesale trade affiliates accounted for 9 percent of total foreign affiliate assets.[9] Manufacturing accounted for the bulk of foreign affiliate employment with 65 percent. Wholesale trade accounted for 8 percent, and retail trade accounted for 9 percent of total foreign affiliate employment.[10]

U.S. merchandise trade with foreign affiliates

Out of total U.S. merchandise exports of $319.3 billion in 1988, $94.8 billion, or nearly 30 percent, were purchases by foreign affiliates of U.S. multinational corporations. In contrast, of the $446.5 billion of total U.S. merchandise imports, $87.3 billion, or 20 percent, were sales by foreign affiliates to the United States. Thus, while the United States had an overall merchandise trade deficit of $172.2 billion in 1988, transactions of foreign affiliates of U.S. multinational corporations on net resulted in a trade surplus of $7.5 billion.

U.S. exports to foreign affiliates and U.S. imports from foreign affiliates are presented, in aggregate and for 38 countries by country, in Table 1 of this pamphlet. In developed countries, the net merchandise trade position was in surplus for transactions with foreign affiliates. Exports to developed-country affiliates from the United States ($75.7 billion) exceeded imports from developed-country affiliates to the United States ($62.6 billion) by $13.1 billion. However, U.S. imports from affiliates in developing countries ($24.7 billion) exceeded U.S. exports to affiliates in developing countries ($19.1 billion) by $5.6 billion.

Wage rates, profitability, and tax rates of foreign affiliates

Data on the activities of foreign affiliates of U.S. multinational corporations are also available from the Statistics of Income Division of the Internal Revenue Service.[11] The last column of Table 1 presents a measure of the effective rate of tax incurred by foreign affiliates of U.S. multinational corporations in 1986. The effective tax rate is calculated as foreign income taxes paid as a percentage of net earnings and profits of controlled foreign corporations with positive earnings and profits. According to this measure, on average, controlled foreign corporations in 16 of these 38 countries listed in this table had foreign effective tax rates of less than 25 percent.

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[8] Commerce Department, Tables 3, 6, and 11.
[9] Commerce Department, Table 4.
[10] Commerce Department, Table 12.
[11] For an overview of this data, see Margaret P. Lewis, "Controlled Foreign Corporations, 1986," *Statistics of Income Bulletin*, Summer, 1991, pp. 29-50. These statistics are compiled every two years. 1986 is the latest year for which data are currently available.

Table 1 also presents data on average employee compensation and average pre-tax return on manufacturing assets of foreign affiliates of U.S. multinational corporations. Average employee compensation in developed countries is nearly three times greater than that in developing countries. Rates of return on assets in manufacturing varies across countries. In some cases high pre-tax rates of return are associated with low tax rates. This is consistent with the findings of recent economic studies that U.S. multinational corporations shift profits to low-tax jurisdictions.[12]

[12] James R. Hines Jr. and Eric M. Rice, "Fiscal Paradise: Foreign Tax Havens and American Business," National Bureau of Economic Research Working Paper No. 3477, 1990; Harry Grubert and John Mutti, "Taxes, Tariffs and Transfer Pricing in Multinational Corporation Decision Making," manuscript, 1990; and David Harris, Randall Morck, Joel Slemrod, and Bernard Yeung, "Income Shifting in U.S. Multinational Corporations," paper presented at the National Bureau of Economic Research Conference on the International Aspects of Taxation, September 28, 1991.

Table 1.—Summary Data on Trade, Wages, Profitability, And Taxes of Foreign Affiliates of U.S. Multinational Corporations By Selected Countries

Country	1988 U.S. exports to affiliates ($ millions)	1988 U.S. imports from affiliates ($ millions)	1988 Affiliate average employee compensation	1988 Pre-tax average return on manufacturing assets (percent)	1986 average effective tax rate (percent)
All Countries	$94,881	$87,291	$23,653	8.4	30.5
Developed Countries	75,736	62,593	29,820	8.0	34.5
Canada	38,327	36,974	24,966	7.8	37.3
Belgium	2,451	616	35,080	8.0	33.5
Denmark	127	119	36,872	8.1	39.7
France	3,280	1,785	36,382	6.3	40.0
Germany	4,145	2,451	38,839	7.1	45.2
Greece	49	14	16,261	6.9	18.8
Ireland	1,220	1,075	23,477	28.6	4.3
Italy	1,831	1,197	34,626	6.9	35.8
Luxembourg	98	72	41,316	6.5	35.0
Netherlands	4,472	668	34,962	10.7	16.1
Portugal	151	51	12,760	13.0	23.2
Spain	1,028	309	25,134	14.4	26.7
United Kingdom	7,290	5,122	26,198	9.5	32.7
Austria	155	n.a.	30,539	10.3	21.6
Switzerland	1,244	261	52,604	16.5	11.8
Sweden	410	177	34,480	7.3	54.5
Japan	6,193	9,939	40,482	3.6	50.6
Australia	2,490	1,489	17,415	7.9	41.0
New Zealand	200	66	20,585	4.0	29.5
South Africa	219	20	9,821	6.4	27.0

Table 1.—Summary Data on Trade, Wages, Profitability, And Taxes of Foreign Affiliates of U.S. Multinational Corporations By Selected Countries—Continued

Country	1988 U.S. exports to affiliates ($ millions)	1988 U.S. imports from affiliates ($ millions)	1988 Affiliate average employee compensation	1988 Pre-tax average return on manufacturing assets (percent)	1986 average effective tax rate (percent)
Developing Countries	19,055	24,698	10,004	10.0	19.0
Mexico	5,799	5,887	5,638	9.7	29.0
Panama	271	244	7,284	20.7	6.8
Argentina	330	105	10,727	0.5	14.6
Brazil	1,401	2,088	11,423	9.6	29.4
Bahamas	n.a.	80	14,559	n.a.	18.6
Bermuda	36	n.a.	27,188	n.a.	3.3
Netherlands Antilles	21	n.a.	14,545	26.7	9.0
Liberia	n.a.	n.a.	n.a.	n.a.	1.8
Nigeria	52	836	7,823	8.4	37.3
Saudi Arabia	138	n.a.	39,019	6.9	0.7
Hong Kong	2,258	2,011	13,699	2.5	14.5
Indonesia	164	484	9,872	17.0	55.2
Korea, Republic of	828	1,105	11,581	4.1	28.1
Malaysia	1,207	1,631	6,547	12.2	32.8
Philippines	382	532	4,077	11.9	42.8
Singapore	1,813	3,261	12,190	20.2	4.9
Taiwan	511	1,582	11,248	14.8	11.2
Thailand	402	n.a.	5,893	5.5	28.1

Notes:

n.a.—not available. Some cells reporting disaggregated data have been suppressed by the Commerce Department and the Statistics of Income Division in order to preserve confidentiality.

See the Appendix to this pamphlet for further explanatory notes relating to the above data.

III. DESCRIPTION OF PRESENT-LAW TAX RULES

A. Overview

The United States exerts jurisdiction to tax all income, whether derived in the United States or elsewhere, of U.S. citizens, residents, and corporations.[13] By contrast, the United States taxes nonresident aliens and foreign corporations only on income with a sufficient nexus to the United States.[14] In the case of income earned by a U.S.-owned foreign corporation, generally no U.S. tax is imposed until that income is distributed to the U.S. shareholders as a dividend. However, in the case of certain foreign corporations with U.S. shareholders, various anti-deferral regimes contained in the Internal Revenue Code operate to tax U.S. shareholders currently on certain earnings of the foreign corporation (or impose an interest charge on the U.S. shareholder when income is realized at the shareholder level).

Generally, the United States cedes primary right to tax income derived from sources outside of the United States to foreign governments. Thus, the Code provides a credit against the U.S. income tax imposed on foreign source taxable income to the extent of foreign taxes paid on that income. To implement properly the rules for computing the foreign tax credit (and for other purposes), the statute and regulations set forth an extensive set of rules to determine the source, either U.S. or foreign, of items of income, and to allocate and apportion items of expense against those categories of income.

Other special rules which may affect an outbound investment of a taxpayer are provided in the Code. For example, the Code and regulations set forth rules for determining transfer prices with respect to related party transactions in order to assure those transactions are conducted at arm's length. Rules are also provided with respect to the treatment of business property transferred between domestic corporations and foreign affiliates.

The tax rules of foreign countries that apply to inbound investments vary widely. For example, some foreign countries impose income tax on inbound investment at higher effective rates than are imposed by the United States on outbound foreign investment. In such cases, the allowance of a foreign tax credit by the United States is likely to eliminate any U.S. tax on income from operations in such a country. On the other hand, operations in countries with low statutory tax rates or rules that permit generous de-

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[13] For a more complete discussion of U.S. taxation of foreign investment by U.S. citizens, residents, and corporations, see Joint Committee on Taxation, *Factors Affecting the International Competitiveness of the United States*, Part Two (JCS-6-91), May 30, 1991.

[14] For a discussion of the U.S. tax rules affecting investment in the United States by foreign persons, see Joint Committee on Taxation, *Background and Issues Relating to the Taxation of Foreign Investment in the United States* (JCS-1-90), January 23, 1990.

ductions, or in countries that provide tax incentives (e.g., tax holidays) to foreign investors are apt to be taxed at effective tax rates lower than U.S. rates. In such cases, the United States generally will tax a portion of the foreign earnings at some point unless, for example, the taxpayer is permitted to use excess foreign tax credits from operations in high-tax countries to offset the U.S. tax on the income from operations in the low-tax country.

Some countries that tax inbound investment at especially low effective tax rates are sometimes referred to as "tax havens." This term has been used to cover a broad spectrum of possible legal systems.[15] At one end of the spectrum are countries that are simply havens for passive portfolio investment. In some cases such countries may have tax, bank secrecy, and other laws designed to foster a large financial services industry that caters to those wishing to secrete their assets or activities from the eyes of their home country governments. Current anti-deferral rules in the Code are designed with these countries, among others, in mind. At the other end of the spectrum, the term tax haven has been used to refer to countries whose tax and other laws are designed only to attract direct investment in legitimate, openly conducted, local business operations such as manufacturing.[16] The latter type of "tax haven" provides the relevant factual background for proposals such as H.R. 2889.

The Internal Revenue Manual provides for the guidance of revenue agents a list that purports to represent some, but not all, of the world's tax haven countries of all types. The list includes Antigua, Austria, Bahamas, Bahrain, Barbados, Belize, Bermuda, the British Virgin Islands, the Cayman Islands, the Cook Islands, Costa Rica, the Channel Islands, Gibraltar, Grenada, Hong Kong, Ireland,[17] the Isle of Man, Liberia, Liechtenstein, Luxembourg, Monaco, Nauru, the Netherlands, the Netherlands Antilles, Vanuatu, Panama, Singapore,[18] St. Kitts, St. Vincent, Switzerland, the Turks and Caicos Islands.[19] James Hines and Eric Rice add the following countries: Anguilla, Andorra, Cyprus, Dominica, Jordan,

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[15] See, generally, Richard A. Gordon, "Tax Havens and Their Use by United States Taxpayers—An Overview," U.S. Department of the Treasury, January 12, 1981 (IRS Publication 1150 (4-81)).

[16] Recently it has been reported that U.S. domestic companies have gone abroad to establish back-office operations, such as claims processing in the case of health insurance providers, that support their U.S. market. Wysocki, *Overseas Calling: American Firms Send Office Work Abroad to Use Cheaper Labor*, Wall St. J., August 14, 1991, at A1, col. 6. The tax consequences, if any, of moving such operations abroad would depend on issues such as whether the relocated operation were separately incorporated or treated as a profit center for tax or financial accounting purposes. If the operations are so treated, then generally the tax and policy analysis applicable to manufacturing abroad would also be applicable to service operations located abroad.

[17] For an example of tax and other incentives offered by the Republic of Ireland, see generally *Bausch & Lomb Inc. v. Commissioner*, 92 T.C. 525, 560-65 (1989), *aff'd*, 933 F.2d 1084 (2d Cir. 1991). For the taxable years in question, 1979 through 1982, Ireland offered inducements including (1) a capital grant of 45 percent of the total investment for facilities in the selected city, (2) low-cost lease financing on 35 percent of the total investment, (3) training grants to cover the cost of training employees of the operation, (4) a partially completed building in the selected city, and (5) a tax holiday on all export profits for approximately ten years. Since that time, Irish corporate tax incentives have been revised.

[18] For an example of tax and other incentives offered by the Government of Singapore, see generally *Sundstrand Corp. v. Commissioner*, 96 T.C. 226, 256-60 (1991).

[19] Internal Revenue Manual—Audit, section 4233, exhibit 500-8 (11-88).

Lebanon, Macao, Maldives, Malta, Marshall Islands, Montserrat, St. Lucia, and St. Martin.[20]

B. U.S. Taxation of Income Earned Through Foreign Corporations

1. Direct and indirect operations

U.S. citizens and residents and U.S. corporations (collectively, "U.S. persons") that conduct foreign operations directly (that is, not through a foreign corporation) include income (or loss) from those operations on the U.S. tax return for the year the income is earned or the loss is incurred. The United States taxes that income currently. The foreign tax credit (discussed below in III.C.) may reduce or eliminate the U.S. tax on that income, however.

U.S. persons that conduct foreign operations through a foreign corporation generally pay no U.S. tax on the income from those operations until the foreign corporation repatriates its earnings to the United States.[21] The income appears on the U.S. owner's tax return for the year it comes home, and the United States imposes tax on it then. The foreign tax credit may reduce the U.S. tax.

In general, two kinds of transactions are repatriations that end deferral and trigger tax. First, in the case of any foreign corporation, an actual dividend payment ends deferral; any U.S. recipient must include the dividend in income. Second, in the case of a "controlled foreign corporation" (defined below), an investment in U.S. property, such as a loan to the lender's U.S. parent or the purchase of U.S. real estate, is also a repatriation that ends deferral (Code sec. 956). In addition to these two forms of repatriation, a sale of shares of a foreign corporation may trigger tax, sometimes at ordinary income tax rates (sec. 1248 or sec. 1246). Or a foreign corporation may pay royalties, interest, or other deductible amounts to U.S. persons; foreign tax credit issues aside (see part III.C.), these payments are included in the U.S. tax base, and may reduce the foreign country's tax base.

Since 1937, the Code has set forth one or more regimes providing exceptions to the general rule deferring U.S. tax on income earned indirectly through a foreign corporation. The primary anti-deferral regime set forth in the Code is the set of controlled foreign corporation rules (secs. 951-964), discussed below. Other anti-deferral regimes set forth in the Code, but not discussed in this pamphlet, are the foreign personal holding company rules (secs. 551-558), the passive foreign investment company (PFIC) rules (secs. 1291-1297), the personal holding company rules (secs. 541-547), the accumulated earnings tax (secs. 531-537), and the rules for foreign investment companies (sec. 1246) and electing foreign investment companies (sec. 1247).

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[20] James R. Hines Jr. and Eric M. Rice, "Fiscal Paradise: Foreign Tax Havens and American Business," National Bureau of Economic Research Working Paper No. 3477, Appendix Table A (1990). Hines and Rice cite three sources: Internal Revenue Manual; A. Beauchamp, *Guide Mondial des Paradis Fiscaux*, Paris: Editions Grasset & Fasqualle (1983); and C. Doggart, *Tax Havens and Their Uses*, London: Economist Intelligence Unit (1983).&N

[21] The foreign corporation itself generally will not pay U.S. tax unless it has income effectively connected with a trade or business carried on in the United States, or has certain generally passive types of U.S. source income.

In some cases, a U.S. corporation or other U.S. person finds it practical to conduct its foreign operations through a U.S. corporation. In other cases, the Code permits a business that may be carried on through a foreign corporation for non-tax reasons to be treated for tax purposes as though carried on through a U.S. corporation. For example, certain foreign corporations engaged in an insurance business are permitted to elect to be treated as domestic for most U.S. tax purposes (sec. 953(d), discussed below in III.B.2.c.). In addition, certain corporations organized under the laws of Canada or Mexico and maintained solely for the purpose of complying with the law of those countries as to title and operation of property may at the option of a domestic parent corporation be treated as domestic companies. In other cases, practical difficulties may have prevented other foreign operations from being conducted in U.S. corporate form, but no such election is available.

2. Controlled foreign corporations

a. General definitions

A controlled foreign corporation is defined in the Code generally as any foreign corporation if U.S. persons own more than 50 percent of the corporation's stock (measured by vote or value), taking into account only those U.S. persons that own at least 10 percent of the stock (measured by vote only) (sec. 957).[22] Stock ownership includes not only stock owned directly, but also all stock owned indirectly or constructively (sec. 958).

Deferral of U.S. tax on undistributed income of a controlled foreign corporation is not available for certain kinds of income (sometimes referred to as "subpart F income") under the Code's subpart F provisions. When a controlled foreign corporation earns subpart F income, the United States generally taxes the corporation's 10-percent U.S. shareholders currently on their pro rata share of the subpart F income. In effect, the Code treats those U.S. shareholders as having received a current distribution out of the subpart F income. In this case, also, the foreign tax credit may reduce the shareholders' U.S. tax on that deemed distribution.

Subpart F income typically is income that is relatively movable from one taxing jurisdiction to another and that is subject to low rates of foreign tax. Subpart F income consists of foreign base company income (defined in sec. 954), insurance income (defined in sec. 953), and certain income relating to international boycotts and other violations of public policy (defined in sec. 952(a)(3)-(5)). Subpart F income does not include the foreign corporation's income from sources within the United States that is effectively connected with the conduct of a trade or business within the United States (sec. 952(b)). However, effectively connected income also includes certain types of foreign source income, including certain foreign source income from inventory sales attributable to an office or other fixed place of business in the United States. All effectively connected income, whether foreign or domestic source, is subject to

[22] As described below in III.B.2.c., a controlled foreign corporation is defined differently in the case of a foreign corporation engaging in certain insurance activities (see secs. 953(c) and 957(b)).

current U.S. taxation in the hands of the foreign corporation, whether or not the foreign corporation is U.S. controlled.[23]

b. Foreign base company income

In general

Foreign base company income includes five categories of income: foreign personal holding company income, foreign base company sales income, foreign base company services income, foreign base company shipping income, and foreign base company oil-related income (sec. 954(a)). In computing foreign base company income, amounts of income in these five categories are reduced by allowable deductions (including taxes and interest) properly allocable, under regulations, to such amounts of income (sec. 954(b)(5)).

Foreign personal holding company income

One major category of foreign base company income is foreign personal holding company income (sec. 954(c)). For subpart F purposes, foreign personal holding company income generally consists of interest, dividends, annuities, net gains from sales of certain types of property (including property which does not generate active business income), net commodities gains, net foreign currency gains, related party factoring income, and some rents and royalties.[24]

Other categories of foreign base company income

Other categories of foreign base company income include foreign base company sales and services income, consisting respectively of income attributable to related party purchases and sales routed through the income recipient's country if that country is neither the origin nor the destination of the goods, and income from services performed outside the country of the corporation's incorporation for or on behalf of related persons. Foreign base company income also includes foreign base company shipping income. Finally, foreign base company income generally includes "downstream" oil-related income, that is, foreign oil-related income other than extraction income.[25]

Foreign base company sales income generally consists of sales income deflected to a controlled foreign corporation located in a country that is neither the origin nor the destination of the goods (sec. 954(d)).[26] For example, foreign base company sales income would include gain realized by a controlled foreign corporation that is incorporated in a low-tax foreign country on the sale of a U.S.-manufactured item to an unrelated party for use in a high-tax for-

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[23] Conduct of a U.S. trade or business may impact the tax liability of the U.S. shareholder as well, via the operation of section 956.

[24] Foreign personal holding company income does not include rents derived from unrelated parties in the active conduct of a trade or business. The provision of services related to the leased property may result in a characterization of the rental activity as the active conduct of a trade or business, as distinguished from a purely passive activity (Treas. Reg. sec. 1.954-2(d)(1)(ii)).

[25] Foreign base company oil-related income does not include income from sources within a possession of the United States.

[26] Foreign base company sales income generally does not, however, include income in connection with agricultural commodities which are not grown in the United States in commercially marketable quantities.

eign country if the foreign corporation had purchased the item from its controlling U.S. shareholder. Similarly, foreign base company sales income would include gain realized by a controlled foreign corporation that is incorporated in a low-tax foreign country on the sale of a foreign-manufactured item to an unrelated party for use in the United States if the foreign corporation had purchased the item from a related controlled foreign corporation in a different foreign country. The application of the foreign base company sales rule in this example limits the ability of taxpayers to exploit the weaknesses of the transfer pricing rules (discussed below in III.E.) for U.S. tax purposes through the use of intermediate companies in low-tax countries.

Foreign base company services income includes income from services performed (1) for or on behalf of a related party and (2) outside the country of the controlled foreign corporation's incorporation (sec. 954(e)). This rule taxes some U.S. shareholders who contrive to provide services through controlled corporations established in low-tax countries. Treasury regulations provide that the services of the foreign corporation will be treated as performed for or on behalf of the related party if, for example, a party related to the foreign corporation furnishes substantial assistance to the foreign corporation in connection with the provision of the services (Treas. Reg. sec. 1.954-4(b)(1)(iv)).

c. Insurance income

In general

Subpart F insurance income is another category of income that is subject to current taxation under subpart F (sec. 953). Subpart F insurance income includes any income attributable to the issuing (or reinsuring) of any insurance or annuity contract in connection with risks in a country (for example, the United States) other than that in which the insurer is created or organized.[27] For this purpose, a qualified insurance branch of a controlled foreign corporation may be treated as a corporation created or organized in the country of its location (sec. 964(d)).

The amount of income subject to current tax under subpart F as insurance income is the amount that would be taxed under subchapter L of the Code if it were the income of a domestic insurance company (subject to the modifications provided in sec. 953(b)). In addition, as described above, investment income associated with same-country risk insurance is also included in subpart F income as foreign personal holding company income. Thus, for an insurance controlled foreign corporation, deferral generally is limited to underwriting income from same-country risk insurance.

For purposes of subpart F insurance income, a controlled foreign corporation is specially defined to include, in addition to any corporation that meets the usual test of 50-percent ownership by 10-percent shareholders (discussed above), any foreign corporation that satisfies a test of 25-percent ownership by 10-percent shareholders

[27] In addition, subpart F applies to income attributable to an insurance contract in connection with same-country risks as the result of an arrangement under which another corporation receives a substantially equal amount of premiums for insurance of other-country risks.

if more than 75 percent of the corporation's gross premium income is derived from the reinsurance or issuance of insurance or annuity contracts with respect to third-country risks (sec. 957(b)).

Related person (captive) insurance income

In addition, subpart F insurance income that is related person insurance income generally is taxable under subpart F to an expanded category of U.S. persons (sec. 953(c)), with certain exceptions.[28] For purposes of taking into account such income under subpart F, the U.S. ownership threshold for controlled foreign corporation status is reduced to 25 percent or more. Any U.S. person who owns (directly, indirectly, or constructively) any stock in a controlled foreign corporation, whatever the degree of ownership, is treated as a U.S. shareholder of such corporation for purposes of this 25-percent U.S. ownership threshold and exposed to current tax on the corporation's related person insurance income.

Election by a foreign insurance company to be treated as a U.S. corporation

As noted above, any controlled foreign corporation engaged in the insurance business may elect to be treated as a U.S. corporation generally for all purposes under the Code (sec. 953(d)). A foreign corporation making the election generally is treated under the rules of the Code as if it transferred its assets to a domestic corporation in a reorganization. (See discussion of transfers of property into the United States in III.F., below.) However, special rules apply to pre-1988 earnings and profits, and an additional tax (up to $1,500,000) is imposed based on capital and accumulated surplus as of December 31, 1987. Dividends paid out of earnings and profits of certain pre-election years are treated as coming from a foreign corporation. An electing corporation that terminates its election is treated under the general rules of the Code as a domestic corporation that transferred its assets to a foreign corporation in a reorganization. (See discussion of transfers of property outside the United States in III.F., below.)

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[28] The Code provides three exceptions to the special subpart F rules for related person (captive) insurers. First, related person insurance income of a captive insurer is not currently taxable by reason of these rules if the corporation's gross related person insurance income for the taxable year is less than 20 percent of its gross insurance income for the year. Second, related person insurance income of a captive insurer is not currently taxable under this provision if less than 20 percent of the total combined voting power of all classes of stock of the corporation entitled to vote and less than 20 percent of the total value (both stock and policies) of the corporation during the taxable year are owned (directly or indirectly) by persons who are insured under any policies of insurance or reinsurance issued by the corporation, or by persons related to such persons. Persons that are insured indirectly (as well as directly) are included in the group of insured shareholders and shareholders related to insureds for purposes of determining whether the foreign corporation is less than 20 percent owned by insureds or persons related to insureds. Third, a corporation which is a controlled foreign corporation solely by virtue of the special rules for captive insurers may elect to treat related person insurance income that would not otherwise be taxed as income effectively connected with the conduct of a U.S. trade or business, taxable under section 882, as income that is effectively connected with a U.S. trade or business. The income deemed to be effectively connected under this election is excluded from subpart F income. To make such an election, the foreign corporation must waive all U.S. treaty benefits (other than benefits with respect to the branch profits and branch interest taxes) with respect to its related person insurance income under any treaties (including treaties other than tax treaties) between the United States and any foreign country. Electing corporations continue to be taxed currently on their related person insurance income, inasmuch as effectively connected income is taxed currently.

d. Certain operating rules

Income inclusion

When a controlled foreign corporation earns foreign base company income or subpart F insurance income, the United States generally taxes the corporation's U.S. shareholders currently on their pro rata share of the that income (sec. 951). If more than 70 percent of a controlled foreign corporation's gross income is foreign base company income and/or subpart F insurance income, then generally all of its income is treated as foreign base company income or insurance income (whichever is appropriate) (sec. 954(b)(3)(B)). Earnings and profits of a controlled foreign corporation that are (or previously have been) so included in the incomes of the U.S. shareholders are not taxed again when such earnings are actually distributed to the U.S. shareholders (sec. 959(a)(1)).

There are several exceptions to these current inclusion rules, however. For example, none of a controlled foreign corporation's gross income for a taxable year is treated as foreign base company income or subpart F insurance income if the sum of the corporation's gross foreign base company income and gross subpart F insurance income for the year is less than the lesser of 5 percent of its gross income, or $1 million (sec. 954(b)(3)(A)). Income otherwise subject to current taxation as foreign base company income can be excluded from subpart F if the income was not in fact routed through a controlled foreign corporation in which the income bore a lower tax than would be due on the same income earned directly by a U.S. corporation (sec. 954(b)(4)). Subpart F employs an objective test to determine whether income that has been earned through a controlled foreign corporation in fact has been subject to less tax than it would have borne if the income had been earned directly. Under this rule, subpart F income (other than foreign base company oil-related income) does not include items of income received by a controlled foreign corporation if the taxpayer chooses to establish, to the satisfaction of the Secretary, that the income, measured under U.S. tax rules, was subject to an effective rate of foreign tax equal to at least 90 percent of the maximum U.S. corporate tax rate. In addition, amounts are not included under subpart F to the extent foreign base company income and subpart F insurance income exceed the controlled foreign corporation's current earnings, or to the extent that the income is offset by certain qualified deficits generated either by the controlled foreign corporation in prior years, or by certain related controlled foreign corporations in the current year.

Allowance of foreign tax credit

U.S. corporate shareholders of a controlled foreign corporation who include subpart F income in their own gross incomes are also treated as having paid the foreign taxes actually paid by the controlled foreign corporation on that income, to the same general extent as if they had received a dividend distribution of that income (sec. 960). Therefore, the U.S. corporate shareholders may claim foreign tax credits for those taxes to the same general extent

as if they had received a dividend.[29] (See the discussion of the indirect foreign tax credit in III.C., below.[30])

e. Gain from certain sales or exchanges of stock in certain foreign corporations

If a U.S. person sells or exchanges stock in a foreign corporation, or receives a distribution from a foreign corporation that is treated as an exchange of stock, and, at any time during the five-year period ending on the date of the sale or exchange, the foreign corporation was a controlled foreign corporation and the U.S. person was a 10-percent shareholder (counting stock owned directly, indirectly, and constructively), then the gain recognized on the sale or exchange is included in the shareholder's income as a dividend, to the extent of the earnings and profits of the foreign corporation which were accumulated during the period that the shareholder held stock while the corporation was a controlled foreign corporation (sec. 1248).[31] For this purpose, earnings and profits of the foreign corporation do not include amounts that had already been subject to current U.S. taxation (whether imposed on the foreign corporation itself or the U.S. shareholders), such as amounts included in gross income under section 951, amounts included in gross income under section 1247 (applicable to foreign investment companies), amounts included in gross income under section 1293 (applicable to certain passive foreign investment companies), or amounts that were effectively connected with the conduct of a trade or business within the United States (sec. 1248(d)). The Code provides certain special rules to adjust the proper scope and application of section 1248 (sec. 1248(e)-(i)).

Amounts subject to treatment under section 1248, in accordance with their characterization as dividends, carry deemed-paid foreign tax credits that may be claimed by corporate taxpayers under section 902 (discussed below in III.C.).

f. Information reporting requirements

Each U.S. person that controls a foreign corporation is required to report certain information to the IRS with respect to the foreign corporation (sec. 6038(a)). The required information pertains to the stock ownership, capitalization, assets and liabilities, and earnings of the corporation, as well as transactions between the corporation and related persons, plus such other information as may be specified in regulations. Penalties for failure to comply with the requirements of section 6038(a) include a dollar penalty (sec. 6038(b)) and a reduction in the amount of foreign tax credits that may be claimed

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[29] Individual U.S. shareholders of a controlled foreign corporation who include subpart F income in their own gross incomes may elect to be taxed as corporations on their subpart F income (sec. 962). Therefore, electing individual U.S. shareholders, like corporate shareholders, may claim foreign tax credits for the foreign taxes actually paid by the controlled foreign corporation on that income to the same general extent as if they had received a dividend. As a result of this election, however, any subsequent actual distribution of those earnings will not be treated as previously taxed income under section 959.

[30] Because actual distributions by a controlled foreign corporation are not treated as dividends to the extent that the distributions are out of previously taxed income, they generally do not (subject to an exception under secs. 960(a)(3) and (b)) carry further eligibility for deemed-paid foreign tax credits.

[31] A special limitation applies in the case of the sale or exchange by an individual of stock held as a long-term capital asset (sec. 1248(b)).

by the controlling U.S. person (sec. 6038(c)). Control for these purposes means ownership of more than 50 percent of the vote or value of the stock, including stock owned indirectly or by attribution (sec. 6038(e)).

C. Foreign Tax Credit

In general

Congress enacted the foreign tax credit in 1918 to prevent U.S. taxpayers from being taxed twice on their foreign source income; once by the foreign country where the income is earned, and again by the United States. The foreign tax credit generally allows U.S. taxpayers to reduce the U.S. income tax on their foreign income by the foreign income taxes they pay on that income. The foreign tax credit does not operate to offset U.S. income tax on U.S. source income.

A credit against U.S. tax on foreign income is allowed for foreign taxes paid or accrued by a U.S. person (Code sec. 901). In addition, a credit is allowed to a U.S. corporation for foreign taxes paid by certain foreign subsidiary corporations, and deemed paid by the U.S. corporation upon a dividend received by, or certain other income inclusions of, the U.S. corporation relating to earnings of the foreign subsidiary (the "deemed-paid" or "indirect" foreign tax credit) (sec. 902).[32]

Foreign tax credit limitation

A premise of the foreign tax credit is that it should not reduce a taxpayer's U.S. tax on its U.S. source income; rather, it should only reduce U.S. tax on its foreign source income. Permitting the foreign tax credit to reduce U.S. tax on U.S. income would in effect cede to foreign countries the primary right to tax income earned from domestic sources.

Overall and per country limitations

Since 1921, a limitation has been imposed on the amount of foreign tax credits that can be claimed in a year. This limitation prevents a taxpayer from using foreign tax credits to offset U.S. tax on U.S. source income. Historically, the foreign tax credit limitation has been determined either on the basis of total foreign income (an "overall" limitation or method), or on the basis of foreign income earned in a particular country (a "per-country" limitation or method), or both.

An overall limitation generally is calculated by prorating a taxpayer's pre-credit U.S. tax on its worldwide taxable income between its U.S. source and foreign source taxable income. The ratio of the taxpayer's foreign source taxable income to its worldwide taxable income is multiplied by the taxpayer's total pre-credit U.S.

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[32] The deemed paid credit applies to dividends from foreign corporations with respect to which the recipient U.S. corporate shareholder owns at least 10 percent of the voting stock. Additionally, a U.S. corporation may be deemed to have paid foreign taxes actually paid by a second- or third-tier foreign corporation. The amount of foreign tax eligible for the credit is computed as a fraction of the foreign tax paid (or deemed paid) by the distributing foreign corporation. The numerator of the fraction is the amount of the recipient shareholder's dividend (or income inclusion); the denominator generally is the foreign corporation's post-1986 undistributed earnings and profits.

tax to establish the amount of U.S. tax allocable to the taxpayer's foreign source income and, thus, the upper limit on the foreign tax credit for the year.

Under a per-country method, the taxpayer calculates the foreign tax credit limitation separately for each country in which it earns income. The foreign source income taken into account in each calculation is the foreign source income derived from the foreign country for which the limitation is being determined.

From 1921 until 1932, an overall limitation was in effect. Between 1932 and 1954, foreign tax credits were limited to the lesser of the overall or per-country limitation amount. In 1954, Congress amended the law to allow only a per-country limitation. From 1960 to 1975, taxpayers were permitted to elect between an overall and a per-country method. Since 1976, an overall limitation has been mandatory.

An overall limitation generally offers taxpayers an advantage over a per-country limitation. An overall method permits "averaging" for limitation purposes of the income and losses generated in, and the taxes paid to, the various foreign countries in which a taxpayer operates and other income and losses sourced outside the United States. An overall method also permits averaging of tax rates applied to different types of income. A per-country limitation, on the other hand, permits taxes paid to any foreign country to offset only that portion of U.S. tax which is allocable to sources within that country.

Separate limitation categories

Under present law's overall foreign tax credit limitation, the total amount of the credit may not exceed the same proportion of the taxpayer's U.S. tax which the taxpayer's foreign source taxable income bears to the taxpayer's worldwide taxable income for the taxable year (sec. 904(a)). In addition, the foreign tax credit limitation is calculated separately for various categories of income generally referred to as "separate limitation categories" or "separate baskets." That is, the total amount of the credit for foreign taxes *on income in each category* may not exceed the same proportion of the taxpayer's U.S. tax which the taxpayer's foreign source taxable income *in that category* bears to the taxpayer's worldwide taxable income for the taxable year. In order to compute the foreign tax credit limitations, then, a taxpayer must determine the portion of its taxable income that falls into each applicable category, and determine the portion of its foreign taxes related to the income in each category.[33]

The separate limitation categories include passive income, high-withholding-tax interest, financial services income, shipping income, dividends received by a corporation from each noncon-

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[33] Treas. Reg. sec. 1.904-6(a)(i). Taxes are related to income if the income is included in the base upon which the tax is imposed. A withholding tax generally is related to the income from which it is withheld.

If a tax is related to more than one separate category (because it is imposed on income in more than one category), then the tax is apportioned on an annual basis among the relevant categories according to a formula provided in regulations (Treas. Reg. sec. 1.904-6(a)(ii)). That formula is the foreign tax subject to apportionment multiplied by the ratio of net income subject to that tax that is included in a separate category to the total net income subject to that tax.

trolled section 902 corporation, dividends from a domestic international sales corporation (DISC) or former DISC, certain distributions from a foreign sales corporation (FSC), and taxable income of a FSC attributable to foreign trade income (sec. 904(d)). Income not in a separate limitation category is referred to in the regulations as "general limitation income." Also, a special limitation applies to the credit for taxes imposed on foreign oil and gas extraction income (sec. 907(a)).

Look-through rules apply in the case of dividends received from a controlled foreign corporation if the dividend recipient is a U.S. shareholder in that corporation. Similar treatment is afforded to subpart F inclusions from controlled foreign corporations. Under the look-through rules, the U.S. shareholder's dividend income or subpart F inclusion is allocated among the separate limitation categories to the extent that the dividend or inclusion is attributable to separate limitation earnings and profits of the controlled foreign corporation.

Look-through rules also apply to interest, rents, and royalties received from controlled foreign corporations by U.S. shareholders even though these payments may not represent earnings and profits of the foreign corporation that have been subject to foreign tax. Since the separate limitation rules do not preclude averaging of low- and high-taxed income within the same separate limitation category, application of look-through rules to these types of payments may lead to their effective exemption from tax. Assume, for example, that a domestic corporation earns $100 of foreign source taxable income in the general limitation basket, with respect to which it incurs foreign tax of $40. The corporation would pay no U.S. tax on that income, and would have $6 of excess foreign tax credit. Assume that during the same taxable year, however, the corporation receives a $20 royalty from its wholly owned foreign subsidiary, which royalty incurs no foreign withholding tax and, pursuant to the look-through rules, is attributable to general limitation income of the subsidiary. (The subsidiary would generally deduct the royalty for purposes of computing its tax base in its home country.) In this case, the domestic corporation has $120 of foreign source general limitation income with respect to which it incurs pre-credit U.S. tax liability of $40.80. The corporation is permitted to average its low- and high-taxed general limitation income and utilize all of its $40 of creditable foreign taxes, thus yielding a residual U.S. tax liability of $0.80.[34]

A separate limitation generally is applied to a category of income for one of three reasons: the income's source (foreign or U.S.) can be manipulated; the income typically bears little or no foreign tax; or the income often bears a rate of foreign tax that is abnormally high or in excess of rates on other types of income. Applying a separate limitation to a category of income prevents the application of foreign taxes imposed on one category of income to reduce the U.S. tax on other categories of income. For example, the separate limi-

[34] Absent application of the look-through rules, the royalty income might fall in the separate limitation for passive income. In such a case, the taxpayer would pay no U.S. tax, but have $6 of excess foreign tax credit, with respect to income in the general limitation basket, and would pay full U.S. tax of $6.80 on the income in the passive basket.

tation for passive income generally prevents taxes imposed by a high-tax country on manufacturing income from offsetting U.S. tax on interest earned on a bank deposit placed in a country that does not tax the interest in the hands of the U.S. taxpayer (or its subsidiaries).

D. Source Rules

In general

Rules determining the source of income are important because the United States acknowledges that foreign countries have the first right to tax foreign income, but the United States generally imposes its full tax on U.S. income. The mechanism by which this second goal is carried out in the case of U.S. persons is the foreign tax credit limitation; and the source rules primarily are important for U.S. persons insofar as these rules determine the amounts of their foreign tax credit limitations.[35] That is, a premise of the foreign tax credit is that it should only reduce a taxpayer's U.S. tax on its foreign source income, not a taxpayer's U.S. tax on its U.S. source income. For the foreign tax credit mechanism to function, then, every item of income must have a source: that is, it must arise either within the United States or outside the United States.

In order to compute the foreign tax credit limitation, it is necessary to compute a taxpayer's *taxable* income from foreign sources. Taxable income from foreign sources is computed by (1) determining the items of gross income that are from foreign sources, and then (2) subtracting from that amount of gross income that portion of the taxpayer's deductions that are allocable to foreign source gross income.

Source of items of gross income

Sections 861 and 862 of the Code list items of gross income that arise from sources within the United States ("U.S. source gross income") and from sources outside the United States ("foreign source gross income"), respectively. Under section 861, U.S. source gross income includes, generally, income from sales of inventory property manufactured and sold in the United States, wages and salaries for work performed in the United States, rents and royalties paid for the use of property in the United States, dividends paid by U.S. corporations, and interest paid by U.S. persons. Under section 862, foreign source gross income includes, generally, income from sales of inventory property manufactured and sold outside the United States, wages and salaries for work performed outside the United States, rents and royalties paid for the use of property outside the United States, and dividends and interest paid by persons other than those described in the preceding sentence. Section 863 contains some special rules for determining the source of income, including rules necessary for determining the source of income that is derived partly from within and partly from without the

[35] With respect to foreign persons, the source rules primarily are important in determining the income over which the United States asserts tax jurisdiction (foreign persons are subject to U.S. tax on certain types of U.S. source income as well as on all of their U.S. source (and certain foreign source) income that is effectively connected with a U.S. trade or business).

United States and for sourcing certain income from transportation, space and oceanic activities. Sections 865 and 988 of the Code, added by the Tax Reform Act of 1986, provide rules for determining the source of income from sales and other dispositions of certain types of personal property.

Allocation and apportionment of deductions—in general

After determining the amount of gross foreign source income and U.S. source income, taxpayers must determine *net* (or taxable) foreign source and U.S. source income. This determination brings deductible expenses into play. In general, the primary statutory rule for allocating and apportioning deductions between foreign and domestic income is that there shall be deducted from domestic and foreign source gross income, respectively, the expenses, losses, and other deductions "properly apportioned or allocated thereto" and "a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income" (secs. 861(b) and 862(b)). Furthermore, the Code provides that items of expense, loss, and deduction are to be allocated or apportioned to sources within or without the United States under regulations prescribed by the Secretary (sec. 863(a)).

Although the Code contains some additional rules on the allocation and apportionment of deductions, these statutory rules are relatively recent refinements, enacted in 1986, to the comprehensive rules previously laid down in regulations (until 1986, primarily Treas. Reg. sec. 1.861-8) under the broad statutory authority described above. The regulations are in general designed to serve as the allocation rules for both outbound purposes (generally, computation of a U.S. person's foreign tax credit limitation) and inbound purposes (generally, computation of a foreign person's taxable income effectively connected with a U.S. trade or business).[36]

As expressly provided in the statute, deductions not definitely related to gross income are apportioned on a pro rata basis between domestic and foreign source gross income. The regulations contemplate two other types of deductions: (1) deductions definitely related to all of the taxpayer's gross income, and (2) deductions definitely related to a subset or "class" of the taxpayer's gross income. Division of the taxpayer's gross income into classes for this purpose, and determination of whether a particular deduction is related to that class, is based on the factual relationship between the deduction and the class of gross income. A deduction is considered definitely related to a class of gross income if it is incurred as a result of, or incident to, an activity or in connection with property from which that class of gross income is derived (Treas. Reg. sec. 1.861-8(b)(2)).

Once deductions are associated with a corresponding class of gross income (or all of gross income), an apportionment is made between the so-called "statutory grouping" of income in that class (for foreign tax credit purposes, generally the foreign source gross income within the particular foreign tax credit limitation category

[36] In the case of interest, however, the inbound and outbound rules are separate. Compare Treas. Reg. secs. 1.882-5 and 1.861-9T(d)(2) and (e)(7) (inbound rules) with Treas. Reg. secs. 1.861-9T through 1.861-12T (outbound rules)).

for which the limitation is being computed) and the so-called "residual grouping" (generally all the rest of the income in the class not in the "statutory grouping"). The apportionment method is one which attempts to reflect the factual relationship between the deduction and the grouping of gross income.

Allocation and apportionment of interest expense

One taxpayer rule

In the case of interest expense, regulations generally are based on the approach that money is fungible and that interest expense is properly attributable to all business activities and property of a taxpayer, regardless of any specific purpose for incurring an obligation on which interest is paid. The Code provides that for interest allocation purposes all members of an affiliated group of corporations are generally to be treated as a single corporation (the so-called "one taxpayer rule"). Under the one taxpayer rule, the factors affecting the allocation of interest expense of one corporation may affect the sourcing of taxable income of another related corporation, even if the two corporations do not elect to file, or are ineligible to file, consolidated returns (see, e.g., Treas. Reg. sec. 1.861-11T(g)).

In theory, total fungibility of money would require each dollar of interest expense of a commonly controlled group of companies to be allocated evenly throughout the group. The Code, however, limits fungibility to the "affiliated group." Notably, where foreign corporations are part of the commonly controlled group, their expenses, assets, and income generally are ignored for expense allocation purposes because the statutory definition of affiliated group for this purpose excludes foreign corporations. However, stock in such a foreign corporation held by the affiliated group members is considered an asset for purposes of apportioning interest expense.[37] Affiliated group in this context is defined, with certain exceptions, by reference to the rules for determining whether corporations are eligible to file consolidated returns.[38]

In addition to the statutory differences between the consolidated return and interest allocation definitions of affiliation, regulations provide for further differences. Temporary and proposed Treasury regulations provide that certain corporations not within the general definition of an affiliated group, such as any includible corporation if 80 percent of the vote *or* value of its stock is owned directly *or indirectly* by an includible corporation or by members of an affiliated group, will be considered to constitute affiliated corporations for purposes of the interest expense allocation rules (Treas. Reg. sec. 1.861-11T(d)(6)(i); see also Notice 89-91, 1989-2 C.B. 408).[39]

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[37] An alternative rule that would have taken such expenses and assets into account for interest allocation purposes was passed by the Senate in 1986 and expressly rejected by the 1986 Act conferees.

[38] Under one such exception, certain financial corporations are excluded from the affiliated group for interest allocation purposes. A group or subgroup of two or more such institutions which are affiliated for consolidation purposes may, however, be treated as a single corporation for interest allocation purposes.

[39] Under the affiliation rules for filing consolidated returns, an includible corporation can only be part of an affiliated group if 80 percent of the vote *and* value of its stock is owned *directly* by an includible corporation that itself is in the affiliated group (or by a group of includible corporations in the affiliated group).

Asset-based interest allocation for U.S. shareholders of controlled foreign corporations

As stated above, a U.S. taxpayer (or an affiliated group of U.S. taxpayers) that controls foreign corporations generally does not take into account the expenses, assets, or income of those controlled foreign corporations for expense allocation purposes. Instead, stock in such foreign corporations held by the U.S. taxpayer is considered an asset for purposes of apportioning interest expense of the domestic group members. Moreover, current regulations provide a special rule that directly allocates third-party interest expense of the U.S. taxpayer to interest income from controlled foreign corporations (Treas. Reg. sec. 1.861-10T(e)). This rule generally is referred to as the "netting rule." The rule in the current regulations is actually one of three alternative netting rules that the Treasury Department has proposed since 1986. The first such rule was proposed in 1987 but never took effect.[40] The current rule was proposed in 1988 and took effect as a temporary regulation only for years beginning on or after January 1, 1988.[41] A third alternative was issued in proposed form in March 1991.[42] This third proposal

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[40] Under the first version of the netting rule proposed in 1987, third-party interest paid by the affiliated group generally was to be directly allocated to the (foreign source) interest income of the affiliated group on the debt owed to members of the affiliated group by controlled foreign corporations (to the extent of such income). Proposed Treas. Reg. sec. 1.861-10(c)(3) and (4), INTL-935-86, 1987-2 C.B. 990, 1011-12.

[41] Under the second, and currently applicable version, a direct foreign allocation of third-party interest paid by the affiliated group only occurs if third-party indebtedness in the U.S. affiliated group is substantially disproportionate to the third-party indebtedness of its related controlled foreign corporations. Treas. Reg. sec. 1.861-10T(e), T.D. 8228, 1988-2 C.B. 136, 156-57. Specifically, third-party interest expense may be allocated directly to foreign source interest income from related controlled foreign corporations only to the extent of interest on so-called "excess related-person indebtedness." There is no such excess *unless* the third-party debt-to-asset ratio of the related controlled foreign corporations (in the aggregate) is less than 80 percent of the third-party debt-to-asset ratio of the related U.S. shareholder. If this condition is met and there is excess related-person indebtedness, then U.S. affiliated group interest expense is directly allocated to interest income from the related controlled foreign corporations, but generally only to the extent of interest income of the U.S. affiliated group from related controlled foreign corporations.

[42] The 1991 Treasury proposal would replace the comparison between domestic and foreign third-party debt-to-asset ratios with two comparisons: one between present-year and base-period levels of borrowing by the U.S. shareholder from third parties (adjusting for year-to-year changes in the assets of the U.S. shareholder), and another between present year and base-period levels of lending by the U.S. shareholder to related controlled foreign corporations (adjusting for year-to-year changes in the assets of those controlled foreign corporations). Proposed Treas. Reg. sec. 1.861-10(e), 1991-14 I.R.B. 27. There must be a current-year excess in both levels, as compared to the averages for a five-year base period ("allowable levels"), in order for any direct allocation of third-party interest of the U.S. shareholder to foreign source interest income to occur.

If in the current year the amount of debt of each type exceeds the product of current-year assets times the average of the previous 5 years' ratios of that type of debt to assets of the relevant company or companies, then the lesser of the two excesses serves as the basis for the direct allocation of third-party U.S. shareholder interest expense to foreign source interest income received by the U.S. shareholder from related controlled foreign corporations. The amount of directly allocated interest expense equals a portion of the interest income received by the U.S. shareholder from the related controlled foreign corporations, based on the proportion of the lesser debt increase to total debt of the related controlled foreign corporations to the U.S. shareholder. In no case, however, will there be a direct allocation if either the current year's level of debt of controlled foreign corporations to the U.S. shareholder would have been considered no greater than the "allowable" level as computed for the prior year, or the amount of such debt does not exceed 10 percent of the related controlled foreign corporatiocated interest expense equals a portion of the interest income received by the U.S. shareholder from the related controlled foreign corporations, based on the proportion of the lesser debt increase to total debt of the related controlled foreign corporations to the U.S. shareholder. In no case, however, will there be a direct allocation if either the current year's level of debt of controlled foreign corporations to the U.S. shareholder would have been considered no greater than the "allowable" level as computed for the prior year, or the amount of such debt does not exceed 10 percent of the related controlled foreign corporations' assets.

would be effective for taxable years beginning after 1990 and, at the taxpayer's option, for earlier years beginning after 1987.

According to the Treasury Department, enactment of the one-taxpayer rule in 1986 resulted in a behavioral response by multinational groups designed, in effect, to route the third-party debt of their controlled foreign corporations through their U.S. affiliated groups, thus achieving the benefits of the world-wide group fungibility rule rejected by the 1986 Act conferees.[43] The Treasury Department expressed the view that the more favorable treatment thus achieved encouraged the use of related-party loans, even though other considerations, such as minimizing foreign withholding taxes and favorable local interest rates, might have dictated that the borrowing be incurred by the foreign subsidiary.[44]

E. Transfer Pricing

Overview

In the case of a multinational enterprise that includes both a U.S. and a foreign corporation, the United States may tax all of the income of the U.S. corporation under common control, but only so much of the income of the foreign corporation as satisfies the relevant rules for determining a U.S. nexus. The determination of the amount of income that properly is the income of the U.S. member of a multinational enterprise, and the amount that properly is the income of a foreign member of the same multinational enterprise, is thus critical to determining the amount the United States may tax as well as the amount other countries may tax.

Due to the variance in tax rates (and tax systems) among countries, and possibly for other reasons, a multinational enterprise may have a strong incentive to shift income, deductions, or tax credits among commonly controlled entities to the entity in the most favorable tax jurisdiction in order to arrive at a reduced overall tax burden.[45] Such a shifting of items between commonly controlled entities might be accomplished by setting artificial transfer prices for transactions between group members.

As an illustration of how transfer pricing might reduce taxes, assume a U.S. corporation has a wholly owned foreign subsidiary. The U.S. corporation performs operations in the United States that enable the foreign subsidiary to accomplish the final manufacture of a product for sale to unrelated parties in the United States or abroad. The foreign subsidiary might pay the U.S. corporation for services, for rights to use patents or other intangibles, and for component parts. The subsidiary may, in turn, sell the final products to

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[43] 1991-14 I.R.B. 27, 28.

[44] 1988-2 C.B. at 139.

[45] The relative statutory tax rates of different jurisdictions do not necessarily reflect their relative effective tax rates. Thus, factors other than relative statutory tax rates may affect a multinational's incentive to place income or deductions in a particular tax jurisdiction. Factors that might reduce a high statutory rate to a low effective tax rate might include, for example, the ability to avoid a high statutory tax rate by timing rules permitting significant deferral; or by tax planning permitted under a country's combined internal and treaty tax rules (including for example, routing income to low-tax third country affiliates so that it is not taxed in the home country). The effectiveness of tax administration in a country may also be a factor. Other factors that can affect the level of tax borne by income reported in a particular jurisdiction include the availability of double tax relief (e.g., a foreign tax credit), and liability for customs or other duties.

the U.S. corporation or related persons, in which case the foreign subsidiary receives the sales price of the products. Alternatively the foreign subsidiary might simply receive a fee for manufacturing services from the U.S. corporation, leaving the latter to sell the product. Due to the U.S. parent's control of its subsidiary, the prices charged in transactions between the parent and the subsidiary are not directly subject to market forces. If the foreign subsidiary is established in a low-tax jurisdiction (and assuming that its income would not be currently taxed by the United States), then the U.S. corporation may be inclined to undercharge the foreign subsidiary and have the subsidiary overcharge the parent on transactions between the two. By doing so, a portion of the combined profits of the group from the manufacture and sale of the product would be shifted out of a high-tax jurisdiction (the United States) and into a lower-tax jurisdiction (the foreign corporation's home country).[46] The ultimate result of this process would be a reduced worldwide tax liability of the multinational enterprise.

The case of *Bausch & Lomb, Inc. v. Commissioner*,[47] provides an example of a U.S. manufacturer that possesses an effective monopoly over sophisticated manufacturing technology. That technology is used to produce a product marketed solely through the services and marketing intangibles of the U.S. manufacturer. The manufacturer places the technology in the hands of a foreign subsidiary subject to a complete source-country income tax exemption, and buys the finished products from the foreign subsidiary without, however, legally guaranteeing the subsidiary the price at which it would buy, or whether it would buy, all of its product. In *Bausch & Lomb* it was held possible for the subsidiary to retain in effect one-half of the profit to be generated by sales (at the price charged by the subsidiary) of the product.

Code section 482

Code section 482 grants the Secretary of the Treasury broad authority to allocate income, deductions, credits or allowances between any commonly controlled organizations, trades, or businesses in order to prevent evasion of taxes or clearly to reflect income.[48]

The statute generally does not prescribe any specific reallocation rules that must be followed, other than establishing the general standards of preventing tax evasion and clearly reflecting income. Treasury regulations adopt the concept of the arm's length standard as the method of determining whether reallocations are appropriate. Thus, the regulations attempt to identify the respective amounts of taxable income of the related parties that would have

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[46] By contrast, U.S. companies owning foreign subsidiaries that are located in countries with effective tax rates in excess of the U.S. rates may have an incentive to overcharge for sales from the United States in order to shift profits, and the resulting tax, into the United States.

[47] 933 F.2d 1084 (2d Cir. 1991), *aff'g* 92 T.C. 525 (1989).

[48] Section 482 states in part: "In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses."

resulted if the parties had been uncontrolled parties dealing at arm's length (Treas. Reg. sec. 1.482-1(b)(1)).[49]

The 1986 Act amended section 482 to require that in the case of certain transfers or licenses of intangible property, the income with respect to such transfer or license shall be "commensurate with the income attributable to the intangible." [50] The legislative history of this provision stated that the relationship between related parties is different from the relationship between unrelated parties and that comparable unrelated party transactions often cannot be found, particularly in the case of intangibles. The legislative history stated that the Treasury Department should conduct a comprehensive study of the intercompany pricing rules.[51]

Treasury regulations dealing with the 1986 Act provision have not yet been issued, but the Treasury Department has released a discussion draft study of intercompany pricing issues (commonly referred to as the Treasury "White Paper") discussing the "commensurate with income" standard for intangibles as well as other aspects of section 482. The White Paper generally re-endorsed the concept of the arm's length standard for all types of transfers, including transfers or licenses of intangibles.[52]

F. Taxation of Certain Transfers of Property

Transfers of property outside the United States

In general

Certain transfers of appreciated property, in the course of a corporate organization, reorganization, or liquidation, can be made without recognition of gain to the corporation involved or its shareholders. If the transfer is made out of the United States (an "outbound transfer"), however, a foreign corporation is not considered a corporation unless certain requirements are satisfied. Because corporate status is essential to a tax-free organization, reorganization, or liquidation, treatment of a foreign corporation as a non-corporate entity may result in the recognition of gain realized by the participating corporation and shareholders. This rule is designed to prevent certain tax-free removals of appreciated assets from U.S. tax jurisdiction prior to their sale.

In the case of an outbound transfer of assets by a U.S. person in a transaction other than those described above, the Code imposes an excise tax equal to 35 percent of the unrecognized appreciation with respect to the transferred asset.

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[49] According to an important line of judicial decisions, however, the IRS may not always be empowered under present law to reallocate income among related persons under section 482 on the grounds that the transaction that they engaged in was not one that unrelated parties, acting freely, would have entered into. The IRS may be restricted if certain local laws or regulations apply. See *First Security Bank of Utah*, 405 U.S. 394 (1972), and *Procter & Gamble v. Commissioner*, 95 T.C. 323 (1990) (on appeal, 6th Cir.).

[50] P.L. 99-514, sec. 1231(e)(1).

[51] H.R. Rep. No. 99-426, 99th Cong., 1st Sess. 423-25 (1985).

[52] U.S. Treasury Department (Office of International Tax Counsel and Office of Tax Analysis) and Internal Revenue Service (Office of Assistant Commissioner (International) and Office of Associate Chief Counsel (International)), *A Study of Intercompany Pricing*, Discussion Draft, October 18, 1988, Notice 88-123, 1988-2 C.B. 458.

Exception for property transferred for use in an active trade or business

As a general rule, no gain is recognized on the transfer of property to a foreign corporation for use by such foreign corporation in the active conduct of a trade or business outside of the United States (sec. 367(a)(3)(A)). Notwithstanding this general rule, gain is recognized on the outbound transfer of property falling within any of several categories of "tainted assets" (sec. 367(a)(3)(B)). The categories of tainted assets include: (1) inventory or certain personally created assets; (2) installment obligations, accounts receivable, or similar property; (3) foreign currency or other property denominated in a foreign currency; (4) certain intangible property; and (5) property with respect to which the transferor is a lessor at the time of the transfer, except where the transferee is the lessee. Where tainted assets and other assets are transferred to a foreign corporation for use in an active trade or business, no gain is recognized on the transfer of assets other than the tainted assets.

Transfers of intangible property

Except as provided in regulations, a transfer of intangible property to a controlled corporation as described in section 351 or in certain corporate reorganizations described in section 361 is treated as a sale, and is ineligible for the active trade or business exception (sec. 367(d)(1)).[53] Upon the transfer of intangible property, the transferor is treated as receiving amounts that reasonably reflect the amounts that would have been received under an agreement providing for payments contingent on productivity, use, or disposition of the property (sec. 367(d)(2)). Amounts are treated as received over the useful life of the intangible property on an annual basis. The Code specifies that amounts taken into account by the transferor under this provision are to be commensurate with the income attributable to the transferred intangible.[54]

Domestication of foreign subsidiaries

As a general rule, a foreign corporation is treated as a corporation with respect to transfers of property in the course of a corporate organization, reorganization, or liquidation, except to the extent provided in regulations which are necessary to prevent the avoidance of Federal income taxes (sec. 367(b)). In the case of a complete liquidation of an 80-percent-or-more-owned foreign subsidiary into its U.S. parent corporation, regulations provide that the parent corporation must include in its gross income the liquidating corporation's net positive earnings and profits for all taxable years which are attributable to the stock exchanged (otherwise referred

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[53] Intangible property is defined as any (1) patent, invention, formula, process, design, pattern, or know-how, (2) copyright, literary, musical, or artistic composition, (3) trademark, trade name, or brand name, (4) franchise, license, or contract, (5) method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data, or (6) any similar item, which property has substantial value independent of the services of any individual.

[54] This rule is consistent with the statutorily provided authority to the Treasury Secretary to distribute, apportion, or allocate items of gross income and deductions between and among related taxpayers where necessary in order to prevent evasion of taxes or to clearly reflect the income of any such taxpayer (discussed above in III.E.). In the case of any transfer of intangible property, the Secretary is authorized to allocate the income that is commensurate with the income attributable to the intangible.

to in regulations as the "all earnings and profits amount").[55] Similarly, if a domestic corporation acquires assets of a foreign corporation in a reorganization described in section 368(a)(1)(C), (D), or (F), then generally the exchanging domestic corporation must include in gross income the all earnings and profits amount attributable to the stock exchange (Temp. Treas. Reg. sec. 7.366(b)–7(c)(2)). Absent the regulatory requirement to include the foreign corporation's earnings and profits in the recipient shareholder's gross income, taxpayers would be able to repatriate foreign earnings free of U.S. tax through corporate liquidations or similar restructurings. If the all earnings and profits amount is not included in the shareholder's gross income, then the foreign corporation is not treated as a corporation for the purpose of determining the extent to which gain is recognized as a result of the liquidation (i.e., the liquidation would not qualify as a tax-free liquidation under Code section 332).

[55] Temp. Treas. Reg. sec. 7.367(b)-5(b). Note that proposed Treasury regulations issued August 1991 would continue to require a U.S. shareholder to include in income the "all earnings and profits amount" upon a complete liquidation of a foreign subsidiary corporation (Prop. Treas. Reg. sec. 1.367(b)-3).

IV. DESCRIPTION OF H.R. 2889 AND PRIOR RELATED PROPOSALS

A. Description of H.R. 2889 (American Jobs and Manufacturing Preservation Act of 1991) [56]

In general

H.R. 2889 would impose current tax on U.S. shareholders of a controlled foreign corporation to the extent of the corporation's "imported property income." The bill would also add a new separate foreign tax credit limitation for imported property income, whether earned by a controlled foreign corporation or directly by a U.S. taxpayer.

Imported property income

Imported property income means income (whether in the form of profits, commissions, fees, or otherwise) derived in connection with manufacturing, producing, growing, or extracting imported property; the sale, exchange, or other disposition of imported property; or the lease, rental, or licensing of imported property. For the purpose of the foreign tax credit limitation, income that is both imported property income and U.S. source income is treated as U.S. source income. Foreign taxes on that U.S. source imported property income are eligible for crediting against the U.S. tax on foreign source imported property income. Imported property income does not include foreign oil and gas extraction income or foreign oil-related income as defined in Code section 907(c).

The bill defines "imported property" as property which is imported into the United States by the controlled foreign corporation or a related person. It also includes any property imported into the United States by an unrelated person if, when the property was sold to the unrelated person by the controlled foreign corporation (or a related person), it was reasonable to expect that the property would be imported into the United States or that the property would be used as a component in other property which would be imported into the United States. Imported property does not include any property which is imported into the United States and which, before substantial use in the United States, is sold, leased, or rented by the controlled foreign corporation or a related person for direct use, consumption, or disposition outside the United States, or is used by the controlled foreign corporation or a related person as a component of other property which is so sold, leased, or rented.

The term "import" means entering, or withdrawal from warehouse, for consumption or use. The term "import" for this purpose

[56] H.R. 2889 was introduced on July 15, 1991, by Congressmen Dorgan and Obey.

generally includes licensing or any grant to use marketing or manufacturing intangibles in the United States. For example, assume that a controlled foreign corporation produces a film in a foreign country. The controlled foreign corporation licenses that film to unrelated U.S. persons for viewing in the United States. Assume that the royalty payment is not subject to subpart F under current law because it is derived in the conduct of an active trade or business and it is received from a person other than a related person. Under the bill, the income of the controlled foreign corporation that is attributable to the royalty is subject to current tax under subpart F as imported property income; for foreign tax credit purposes, that subpart F inclusion is U.S. source income.

The term "import" does not include foreign currency, securities, or other financial instruments.

Under the look-through rules of the foreign tax credit limitation, interest, rents, and royalties from a controlled foreign corporation in which the recipient (or, in certain cases, a related party) is a 10-percent owner are to be treated as imported property income to the extent properly allocable to imported property income of the controlled foreign corporation. Thus, foreign taxes imposed on other income could not offset the U.S. tax on this income.

In the case of income that would be both foreign base company sales income and imported property income, that income is to be treated as imported property income.

In the application of subpart F to imported property income, various exceptions obtain. For example, assume that a controlled foreign corporation derives imported property income that is taxed by a foreign country at an effective rate greater than 90 percent of the maximum U.S. rate, and its U.S. shareholder elects the high-tax exception (sec. 954(b)(4)) from subpart F treatment. Subsequently distributed dividends from the controlled foreign corporation will be treated as imported property income on the same pro rata basis that would determine the treatment of a dividend as being distributed in whole or in part out of any other separate limitation category earnings.

Effective date

Under H.R. 2889, these provisions generally would apply to taxable years of foreign corporations beginning after December 31, 1991 and to taxable years of U.S. shareholders within which or with which such taxable years of such foreign corporations end. The amendments to the foreign tax credit limitation rules apply to taxable years beginning after December 31, 1991.

B. Description of Certain Prior Unenacted Proposals on Similar and Related Subjects

1. Proposals to repeal deferral on tax holiday or imported property income [57]

The President's 1973 proposals

In 1973, President Nixon proposed to repeal deferral on two types of income which were not at that time (and are not now) subpart F income. First, the Administration recommended repealing deferral on earnings from new or additional American investments abroad which take advantage of major foreign tax incentives, such as extended tax holidays or cash grants that are not included in taxable income. Second, the Administration recommended repealing deferral in cases where new or additional foreign investment is made by a U.S.-controlled foreign corporation in a low tax country, and exports to the U.S. market account for more than 25 percent of the corporation's total receipts. The rule was to apply only when the effective rate of tax on the income of the controlled foreign corporation was less than 80 percent of the U.S. tax rate. This proposal contemplated exceptions where the President determined that they were in the public interest.[58]

The stated purpose of the proposal was to neutralize distortions in investment decisions and in revenue collections that are caused by features of some foreign tax systems.[59] The Administration stated that it believed, in most cases, that "United States businesses invest abroad not because of an attractive tax situation, but because of business opportunities and marketing requirements." The thrust of the proposal, however, was said to be to deter what "tax motivated foreign investment" there was.[60]

Omnibus Budget Reconciliation Act of 1987

As reported by the Ways and Means Committee and passed by the House, the Omnibus Budget Reconciliation Act of 1987 (the "1987 Act") would have imposed current tax on U.S. shareholders of a controlled foreign corporation to the extent of the corporation's "imported property income." [61] The bill would also have

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[57] The term "runaway plant," which has arisen in connection with historical antecedents of H.R. 2889 (see, e.g., Joint Committee on Taxation, *Tax Reform Proposals: Taxation of Foreign Income and Foreign Taxpayers* (JCS-25-85), July 18, 1985, at 14), has also been used in connection with H.R. 2632, introduced June 12, 1991 by Mr. Stark. H.R. 2632 would tend to reduce the Puerto Rico and possessions tax credit available to domestic corporations for their operations in Puerto Rico or U.S. possessions that may have a substantial adverse effect on employment at facilities in the United States. However, H.R. 2632 does not deal with deferral for income from operations carried on through U.S.-owned foreign corporations in foreign countries, and the application of H.R. 2889 does not turn on the factual connection between operations or employment at particular domestic and foreign facilities.

[58] Department of the Treasury, *Proposals for Tax Change* 159-68 (1973), reprinted in *General Tax Reform: Hearings on the Subject of General Tax Reform Before the House Comm. on Ways and Means*, 93d Cong., 1st Sess. 6901, 7061-70 (1973)); *Trade Reform: Hearings on H.R. 6767 Before the House Comm. on Ways and Means*, 93d Cong., 1st Sess. 156-57, 161-62 (1973) (testimony of George P. Schultz, Secretary of the Treasury). Similar proposals have been introduced in the House since 1973 (see, e.g., H.R. 606, 100th Cong., 1st Sess. (1987); H.R. 1031, 102d Cong., 1st Sess. (1991)).

[59] See *Trade Reform: Hearings on H.R. 6767 Before the House Comm. on Ways and Means*, 93d Cong., 1st Sess. 377-83 (1973) (testimony of Frederic W. Hickman, Assistant Secretary of the Treasury for Tax Policy).

[60] Department of the Treasury, *Proposals for Tax Change* 161 (1973).

[61] H.R. 3545, 100th Cong., 1st Sess., sec. 10147 (1987).

added a new separate foreign tax credit limitation for imported property income, whether earned by a controlled foreign corporation or directly by a U.S. taxpayer. The provision passed by the House in 1987 was essentially identical to H.R. 2889 as introduced by Congressmen Dorgan and Obey in July 1991.

Consistent with the purposes of the proponents of other anti-deferral proposals, the Ways and Means Committee intended by adopting the proposal to reduce the income tax considerations in investment decisions, and to ensure that income arising from the combination of U.S. capital ownership and U.S. use or consumption of the output of that capital should bear tax at no less than the full U.S. rate.[62] The Committee recognized that, in some cases, foreign-made goods will enter the U.S. market not because of tax factors but because of comparative economic advantage of foreign production (such as lower labor costs, absence of environmental regulations, more favorable climate, and so on). The Committee was also informed of the argument that subjecting U.S. owners of foreign subsidiaries that produce foreign goods to current U.S. tax will sometimes create a tax disadvantage for U.S.-controlled foreign corporations vis-a-vis foreign-owned producers of foreign goods destined for the U.S. market. It was noted, however, that then-present law (which is not materially different from the law today) sometimes granted a tax advantage for U.S. enterprises to produce for the U.S. market abroad rather than in the United States. While the goods that a U.S. enterprise manufactures abroad may not be the same as those it might manufacture in the United States, those foreign-manufactured goods may substitute for U.S.-manufactured goods. Given the additional nexus with the United States that arises when production occurs for the U.S. market, it was believed appropriate to place U.S.-owned foreign enterprises that produce for the U.S. market on a par with similar or competing U.S. enterprises instead of placing them on a par with purely foreign enterprises.

It was also recognized that administering special rules for income attributable to goods produced for the U.S. market could prove difficult because of problems inherent in determining the ultimate destination of goods. The difficulty was not unique, however, in that the tax law also contains benefits for taxpayers that turn on the destination of goods, such as the Foreign Sales Corporation rules and an exception from subpart F base company sales income. The existence of these destination standards was thought to indicate that a U.S.-destination test would be administrable. The destination test in the bill was said to be on those existing standards.

2. Proposals affecting tax deferral on a broader class of income

The President's 1961 proposal

Before enactment of the foreign personal holding company rules in 1937, there were no statutory provisions for current U.S. taxation of income earned through the foreign subsidiaries of U.S. taxpayers, other than such rules as there may have been that also

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[62] H.R. Rep. No. 100-391, 100th Cong., 1st Sess. 1102 (1987).

would apply to income earned through domestic subsidiaries of U.S. taxpayers—such as the accumulated earnings tax. Deferral of U.S. tax on income earned through the foreign subsidiaries of widely held U.S. corporations was not disturbed, however, changed until the enactment of the subpart F rules in the Revenue Act of 1962.

In 1961, President Kennedy proposed that earnings of any U.S.-controlled foreign corporation be subject to current U.S. tax in the hands of U.S. shareholders generally, so long as the corporation was not created or organized in a less developed country (LDC). Moreover, even the earnings of a controlled foreign corporation in an LDC would be subject to current U.S. taxation if the corporation was a "tax haven corporation," by which it was meant that more than 20 percent of its income is derived from sources outside the LDC in which it was created. For this purpose special sourcing rules would apply.[63]

In essence, tax deferral was characterized by the Administration as a subsidy to economic development in foreign countries, the incidental private benefit of which did not justify retaining the subsidy absent the foreign policy objective of the subsidy—for example, rebuilding the countries devastated by World War II, or resisting Soviet influence in developing nations.[64]

The President's 1961 proposal thus was justified as eliminating the preferential treatment of foreign investment income as compared to domestic investment income—"to avoid artificial encouragement to investment in other advanced countries as compared with investment in the United States." [65] "During the postwar period the promotion of private foreign investment in both advanced and less developed countries was in the public interest. Times have changed, and the need to stimulate investment in advanced countries no longer exists." [66] "Certainly since the post-war reconstruction of Europe and Japan has been completed, there are no longer foreign policy reasons for providing tax incentives for foreign investment in the economically advanced countries." [67] The LDC exception, on the other hand, was retained "in view of the national objective of aiding the development of less advanced countries." [68] "The free world has a strong obligation to assist in the development of these economies, and private investment has an important contribution to make. Continued income tax deferral for these areas will be helpful in this respect." [69]

The Administration argued that this proposal would positively affect the balance of payments (the opposite view, that the proposal would injure our payments position, was termed "utterly errone-

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[63] Message from the President Relative to Our Federal Tax System, H.R. Doc. No. 140, 87th Cong., 1st Sess. 54 (1961), *reprinted in* Committee on Ways and Means, *Legislative History of the Revenue Act of 1962*, 90th Cong., 1st Sess (1967) (hereinafter referred to as the "President's 1961 Tax Message").

[64] "There can be no proper claim that preferential treatment should be continued merely to perpetuate a private gain." President's 1961 Tax Message 29 (statement of Douglas Dillon, Secretary of the Treasury, before the Ways and Means Committee, May 3, 1961).

[65] *Id.* at 26.

[66] *Id.* at 29.

[67] *Id.* at 7.

[68] *Id.* at 26.

[69] *Id.* at 7.

ous" [70]). However, the inequity of preferential treatment for foreign investment was also stressed: "With the present deferral privilege, an American firm contemplating a new investment and finding cost and market conditions comparable at home and abroad is impelled toward the investment opportunity overseas. This is so because it would thereafter be able to finance expansion on the basis of an interest-free loan from the U.S. Treasury, repayable at the option of the borrower. Tax deferral, after all, is just such a loan." [71]

It was apparently assumed by the Administration that foreign tax rates in the affected countries were not significantly lower than U.S. rates (as is generally the case today).[72] However, it was believed that base company operations (i.e., operations in a tax haven country that are ancillary to the operations of related entities, or sales of related entity products, outside the tax haven country), combined with transfer pricing abuses, would result in low effective foreign income tax rates even for companies with operations in the high-tax jurisdictions of the world.[73]

On the issue of competitiveness, the Administration argued that the need for neutrality of tax treatment between foreign-owned and domestic-owned foreign operations was "overly stressed." [74] Even if a tax difference were to result in a handicap, however, the Administration noted that a choice was required between the above type of neutrality ("capital import neutrality") and neutralizing the tax factor in the U.S. investor's choice between domestic and foreign investment ("capital export neutrality"), since both types of neutrality could not be achieved simultaneously "as long as the tax systems of various countries differ." [75] It was argued "that reasons of tax equity as well as reasons of economic policy clearly dictate that in the case of investment in other industrialized countries we should give priority to tax neutrality in the choice between investment here and investment abroad. . . . Curtailment of foreign investment which can survive only under the shelter of preferential tax treatment can only be in the U.S. interest and in the interest of the world economy." [76]

Subpart F, and the resulting partial repeal of the tax preference for tax haven operations, was enacted in 1962 in place of the President's proposal.

Tax Reduction Act of 1975

As passed by the Senate, the Tax Reduction Act of 1975 would have repealed deferral on earnings of a controlled foreign corporation, without regard to whether the controlled foreign corporation was organized or created in an LDC, and without regard to whether it refrains from earning "tax haven" income. The proposal came into the bill as a floor amendment. The sponsor of the amendment argued that

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[70] *Id.* at 29.
[71] *Id.*
[72] See *id.* at 24, 30.
[73] *Id.* at 6, 25.
[74] *Id.* at 30.
[75] *Id.*
[76] *Id.*

> Tax deferral on foreign income offers tremendous advantages to U.S. corporations which invest abroad. It offers nothing to those which invest at home. It operates as an American subsidy to the overseas operations of U.S. companies. Through this device, we are, in effect, paying U.S. companies to invest abroad, to create jobs abroad, instead of at home.[77]

The proposal was dropped in conference.

The President's 1978 proposal

In 1978 President Carter also proposed repeal of deferral. In support of this proposal, the Treasury Department wrote:

> The fundamental defect in the concept of deferral is that it makes very substantial tax benefits turn upon an artificial factor: whether a foreign corporate charter has been interposed between foreign income and the U.S. taxpayer. In addition to curing this defect, the termination of deferral will eliminate the tax incentive that U.S. taxpayers now have to locate new investment overseas rather than in the United States.
>
> Terminating deferral will permit the rationalization and simplification of U.S. rules for the taxation of foreign income. Termination will help stimulate competition between large multinational corporation and their smaller competitors, by removing tax benefits which accrue principally to the large multinationals. Finally, terminating deferral will reduce the incentive inherent in present law for U.S. taxpayers to avoid U.S. tax by undercharging foreign affiliates for goods, services, research, and home office overhead.[78]

Like the Nixon Administration in 1973, the Carter Administration in 1978 assumed that "the vast majority of investment is made in response to real market forces rather than the lure of the deferral preference." [79] Similarly, the expected practical consequence of

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[77] 121 Cong. Rec. S4365 (daily ed., March 19, 1975) (remarks of Sen. Hartke). A similar proposal had previously been part of bills introduced by Congressman Burke and Senator Hartke between 1971 and 1975, known as the "Burke-Hartke" bills. Even a former Administration figure was quoted by Sen. Hartke on behalf of his bill:

> John Nolan, formerly Deputy Assistant Secretary of the Treasury for Tax Policy, told the President's Commission on International Trade and Investment:
>
> There is a clear-cut bias in our existing tax structure favoring the manufacture of goods abroad through foreign subsidiaries as opposed to exporting, in order to benefit from the deferral of U.S. taxes. . . . the distortion in our tax system simply makes no sense at a time when the United States has substantial balance of payments deficits.

121 Cong. Rec. S4355 (daily ed. March 19, 1975). It is likely, however, that Mr. Nolan's remarks were not intended to justify repeal of deferral, about which he testified in 1970, in his role as Deputy Assistant Treasury Secretary: "This is a sound system." *Tariff and Trade Proposals: Hearings Before the House Committee on Ways and Means*, 91st Cong., 2d Sess. 505 (1970). In that 1970 testimony, Mr. Nolan characterized the existence of deferral for income earned through foreign subsidiaries as an "income tax disadvantage" and an "inequity" from the point of view of the U.S. manufacturer, drawing from this the conclusion that the existence of low foreign taxes necessitated a corresponding reduction in U.S. domestic tax on certain domestic operations through the Domestic International Sales Corporation (DISC) rules, which at that time were not yet law, but merely an Administration proposal. *Id.* at 502–03.

[78] Department of the Treasury, *The President's 1978 Tax Program: Detailed Descriptions and Supporting Analyses of the Proposals* 283 (1978).

[79] Statement of W. Michael Blumenthal, Secretary of the Treasury, before the Ways and Means Committee, January 30, 1978, at p. 34.

the 1978 proposal, like that of the 1973 proposal, was elimination of the distortion of normal market forces that may work to the detriment of overall U.S. investment, in those few cases where low foreign tax rates, coupled with U.S. tax deferral, might provide an artificial tax incentive of U.S. investment.[80]

Option considered in markup of the Tax Reform Act of 1985 (House version of the 1986 Act)

In connection with the Ways and Means Committee markup of tax reform proposals in 1985, the Committee considered a possible option to permit certain U.S.-controlled foreign corporations to elect to be treated as domestic corporations for U.S. tax purposes.[81] Rules generally similar to those of section 367 would have been applied to prevent avoidance of tax on prior earnings and on post-election transfers or deemed transfers. The option was not included in the bill reported by the Committee.

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[80] *Id.*

[81] Joint Committee on Taxation, *Tax Reform Proposals in Connection with Committee on Ways and Means Markup*, (JCS–44–85), September 26, 1985, at 61.

V. ANALYSIS OF ISSUES

A. Capital Export Neutrality and Other Principles of International Taxation

Overview

There is no accepted consensus among various advocates and commentators as to the correct system of taxation of income from international investment. A major issue of contention is whether the more desirable policy is promoted by taxing cross-border investment income at the rate prevailing in the country of the investor or at the rate in the country in which the investment is located. Even if the most economically efficient system can be determined, efficiency may not be a country's sole objective in setting its policy toward the taxation of international investment. Equity considerations and maximization of that country's growth (as opposed to worldwide growth) may also be policy objectives. In addition, the distribution of income—and in particular the distribution of income between capital and labor—can also be a policy goal. Discussion of these issues often refers to one or more of three possible guiding principles of an international tax system: capital export neutrality, capital import neutrality, and national neutrality.

Capital export neutrality refers to a system of international taxation where an investor residing in a particular locality can locate investment anywhere in the world and pay the same tax. Capital export neutrality is a principle describing the rate at which investors pay tax, not to whom they pay. A system in which (contrary to present international practice) only the country of the investor's residence (the "residence country") imposes tax could achieve capital export neutrality because in that case each country could tax all the worldwide income of its residents at the same rate. However, capital export neutrality might also be conceivable under a system in which each country from which income is derived (the "source country") taxes local income and the residence country grants unlimited credits for income taxes paid to foreign governments.[82]

Capital import neutrality refers to a system of international taxation where income from investment located in each country is taxed at the same rate regardless of the residence of the investor. Under capital import neutrality, capital income from all businesses operating in any one locality would be subject to uniform taxation. The nationality of investors in a particular locality would not affect the rate of tax. Capital import neutrality would be achieved if each residence country exempted income earned from foreign ju-

[82] In practice unlimited credits are not permitted, because to do so would in effect relinquish to foreign governments jurisdiction over the domestic tax base.

risdictions and allowed the source country's taxation to be the only taxation on the income of international investors. This is commonly referred to as a "territorial" or an "exemption" system of international taxation.

National neutrality generally refers to a system of taxing outbound investments at a rate greater than domestic investment in order to encourage domestic investment. This policy is most commonly described in terms of allowing only deductions instead of credits for foreign taxes. A deduction would arguably discourage outbound investment, but would align the interests of the taxpayer with the interests of its home country

The Treasury Department discussed the advantages and disadvantages of each of these principles in a 1984 report on tax reform:

> In reaching the decision to continue the worldwide taxation of U.S. taxpayers with allowance of foreign tax credits, the Administration considered and rejected the alternatives of exempting foreign source income from U.S. tax [capital import neutrality], or taxing foreign source income but only allowing a deduction for foreign taxes [national neutrality]. While an exemption approach would in some circumstances facilitate overseas competition by U.S. business with competitors from countries that tax foreign income on a favored basis, such an approach also would favor foreign over U.S. investment in any case where the foreign country's effective tax rate was less than that of the United States. Moreover, there would be a strong incentive to engage in offshore tax haven activity. The longstanding position of the United States that, as the country of residence, it has the right to tax worldwide income is considered appropriate to promote tax neutrality in investment decisions. Exempting foreign income from tax would favor outbound investment at the expense of U.S. investment. The other alternative, to allow only a deduction for foreign taxes, would not satisfy the objective of avoiding double taxation. Nor would it promote tax neutrality; it would be a serious disincentive to make outbound investments in countries where there is any foreign income tax.[83]

From the perspective of fairness, and from the perspective of reducing tax-induced distortions in investment decisions and promoting economic efficiency, capital export neutrality appears to be more defensible than capital import neutrality or national neutrality.[84] However, the interests of U.S. owners of foreign operations

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[83] *The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity*, 383 (May 1985). See also U.S. Treasury Department, *Blueprints for Basic Tax Reform* 99 (January 17, 1977), and Prepared Statement of Kenneth W. Gideon, Assistant Secretary for Tax Policy, Department of the Treasury, in *Pending Bilateral Tax Treaties and OECD Tax Convention: Hearing before the Senate Comm. on Foreign Relations*, 101st Cong., 2d Sess. 8, 11 (1990).

[84] See, for example, Hugh J. Ault and David F. Bradford, "Taxing International Income: An Analysis of the U.S. System and its Economic Premises," National Bureau of Economic Research Working Paper No. 3056 (1989). On page 32 of this study they state:

> The creditability of foreign income taxes is usually justified on the equity grounds of avoiding double taxation and on the efficiency grounds of capital-export neutrality,

Continued

would be best served by capital import neutrality. On the other hand, it can be argued that a policy of national neutrality would increase, at least in the short run, national welfare and labor's share of national income.

Worldwide economic efficiency

Just as free international markets for goods and services result in beneficial "gains from trade," the free flow of funds in capital markets also promotes worldwide economic welfare. In the absence of taxes and other capital market imperfections, investors seek to place their funds in projects with the highest risk-adjusted rate of return, regardless of location. If this were not the case, capital markets would inefficiently allocate capital because savings would not be matched with the most productive investments, and economic welfare would suffer. Any impediments to the free flow of capital generally reduce worldwide economic welfare.

To maximize worldwide economic welfare, government policies would neither penalize nor subsidize the flow of capital. Restrictions on inflows of capital are widely recognized as policies reducing worldwide economic welfare, although they can increase returns to domestic investors who otherwise would face more competition. Conversely, subsidies that increase outbound investment beyond its efficient, free-market level reduce worldwide output and income.

If all nations had the same tax rate, taxation would not distort the allocation of capital across national borders. In the case of equal tax rates—as in the case of the free market—investors would undertake only the most efficient investment projects. However, because of differences in national preferences for the amount and method of taxation, effective tax rates are rarely equal across jurisdictions.

With different rates imposed by each country, taxes may distort investment decisions by drawing investors away from the most productive investments to those with more favorable tax treatment. These distortions to the flow of capital reduce worldwide economic welfare.

Under a system of national neutrality, the tax system may tend to tax outbound investment more heavily than domestic investment in order to increase domestic capital formation. The distortion created under this system prevents the efficient allocation of capital.

In some cases, a policy of capital import neutrality would indeed improve the competitiveness of U.S.-owned foreign operations vis-a-vis foreign-owned foreign operations. However, if taxes are lower abroad, it can result in an excessive amount of outbound investment. Although under capital import neutrality U.S.-owned businesses located abroad may be better able to compete with some foreign-owned corporations in low-tax jurisdictions, capital import neutrality would not improve the overall competitive position of

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which requires that taxes should not influence the country of location of capital. The credit is supposed to make U.S. tax burdens independent of the location of investment, thereby assuring that a U.S. firm will not be influenced in its investment decisions by differences between U.S. and foreign taxes.

U.S.-owned businesses located in the United States that compete on world markets. Furthermore, if taxes in general must be increased to offset the revenues lost to support a policy of capital import neutrality, that policy would put businesses located in the United States at a competitive disadvantage compared to businesses located abroad.

Under a system of pure capital export neutrality, where investors would face the same tax rate no matter where they locate their investment, taxes would not distort the investor's allocation of capital. Instead of reducing the rate of domestic tax on outbound investment to the level of tax imposed by foreign governments (which would be consistent with capital import neutrality), it would be more efficient to enact at the same revenue cost a smaller but equal reduction of rates for both domestic and outbound investment. The latter approach would be consistent with capital export neutrality and would improve the competitiveness of both domestic and outbound investment. In brief, if a tax system must raise a given amount of revenue, capital export neutrality would achieve a more efficient allocation of capital than capital import neutrality.

Equity

Under capital export neutrality, investors with identical income would be taxed equally regardless of the location of their investments. This is consistent with the principle of horizontal equity among U.S. investors.[85] Capital import neutrality and national neutrality both violate the principle of horizontal equity. Capital import neutrality would reduce tax on income from outbound investment below the level of tax on domestic investment income, and on average capital income would be treated more favorably than other types of income. National neutrality, on the other hand, would increase taxes on income from outbound investment and drive down the rate of return available to U.S. investors by foreclosing investment opportunities abroad.

Maximizing national income

Although it may be possible to design a tax system that does not distort international investment and maximizes worldwide income, such a system may not be to the benefit of each individual nation. This disparity between worldwide welfare and national economic welfare occurs because taxation of international investment not only increases worldwide income but also redistributes income across national jurisdictions. The net benefit to each country depends on whether source taxation or residence taxation prevails, and whether that country is a net capital exporter or net capital importer.

Since nations do impose taxation at the source on direct investments, the movement of direct investment—whether foreign or domestically owned—from a foreign to a domestic location can increase national income by increasing the amount of tax collected. If effective tax rates are equal around the world, the U.S. investor is

[85] Horizontal equity means that taxpayers in similar economic circumstances pay similar amounts of tax. See discussion in Joint Committee on Taxation, *Factors Affecting the International Competitiveness of the United States* (JCS-6-91), May 30, 1991, at 292 et seq.

indifferent to whether governments impose source or residence taxation. However, those governments are not indifferent. As perhaps is evidenced by the prevailing tendency to impose tax at source on income from business operations, the question whether source or residence taxation prevails is of major importance to individual nations and to the distribution of income across nations. [86]

Because countries typically tax income arising within their borders, a nation can increase its income through policies that reduce outbound investment by its residents and encourage inbound investment by foreigners. It also can go so far as to penalize outbound investment when it imposes a layer of taxation in addition to foreign taxation at source. Under one possible approach, outbound investment is only in the national interest if the return *after foreign tax* (but before domestic tax) equals the before-tax return on domestic investment. This condition is achieved when a capital exporting nation, in response to foreign source taxation, does not cede taxing jurisdiction over foreign source income (for example, through a foreign tax credit) and allows only a deduction for foreign taxes.[87] Such a policy of national neutrality penalizes outbound investment and aligns the interests of the taxpayer with the interests of its home country—but at the expense of reduced worldwide economic welfare.

Despite what might appear to be the potential for a policy of national neutrality to improve a nation's economic welfare, governments generally have not adopted such policies. If one nation unilaterally attempted to improve its own welfare through a policy of national neutrality, it could be expected that this action would be met by retaliation by other nations that might adopt similar policies which would, in turn, even further reduce economic welfare.[88] If, on the other hand, nations could coordinate their tax policies so that investment decisions were not distorted by taxes, worldwide income could be maximized and all nations could be better off.[89]

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[86] Many authors have discussed these types of welfare effects on taxation. See, for example, Michael J. Boskin, "Tax Policy and the International Location of Investment," in Martin Feldstein (ed.) *Taxes and Capital Formation*, Chicago: University of Chicago Press, 1987, p. 79:

> [D]omestic welfare falls when U.S. firms substitute [outbound investment] for investment at home, because the nation receives only the net-of-foreign-tax return (and only when it is repatriated) rather than the gross return. These welfare effects are augmented by the beneficial effects on labor productivity of greater foreign or direct investment in the United States. Thus, a reduction in taxation of new corporate investment improves welfare through three channels: the standard mechanism, through which the lowering of the marginal tax rate generates new domestic investment opportunities for U.S. firms; a reallocation of the location of investment by U.S. firms toward home and away from abroad; and an increase in [inbound investment by foreign investors.]

[87] Several authors provide a description of how deductions for foreign taxes maximize domestic welfare of a capital-exporting country. See Richard E. Caves, *Multinational Enterprises and Economic Analysis*, Cambridge, England: Cambridge University Press, 1982, pp. 229-231; and Peggy B. Musgrave, *United States Taxation of Foreign Investment Income: Issues and Arguments*, Cambridge, Massachusetts: International Tax Program, Harvard Law School, 1969, p. 134.

[88] In the context of international trade, policies that attempt to promote domestic welfare at the expense of the rest of the world are referred to as "beggar-thy-neighbor" policies.

[89] This view is articulated by Ault and Bradford:

> It is difficult to construct an optimizing model from a national perspective that implies capital-export neutrality, even if it could be achieved without sacrificing revenue to foreign governments. The yield to the domestic economy is net of foreign tax, whereas the yield of domestic investment is gross of domestic tax. National self-interest would seem to imply something like deduction of foreign taxes.

Continued

The distribution of income between capital and labor

The location of investment has important implications for the distribution of income. In general, increased capital formation increases the productivity of labor. With more output per worker, labor income (including wages and other forms of compensation) increases. Relocation of investment from the United States to foreign localities, for whatever reason, will reduce the productivity of U.S. workers and therefore their compensation. The remaining smaller pool of capital in the United States will receive a higher rate of return as investors drop the least profitable investment projects.[90]

Similarly, any increase in inbound investment into the United States increases the productivity of U.S. workers and their income.[91] Increased investment by foreign persons in the United States also reduces the return on capital in the United States. If capital inflows are the result of free-market policies, they generally increase economic welfare. However, not all sectors of the economy necessarily will be better off.

Given the distributional impact of international tax policy, it is not surprising, therefore, that business interests have consistently supported capital import neutrality and opposed both capital export neutrality and national neutrality. Indeed business interests may go even further and support bilateral treaty-based reductions of source country tax which result not simply in neutrality across all investors in a particular country, but preferential tax results for U.S. investors. Business interests have stressed that capital import neutrality is in the national interest on the grounds that

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> It is a serious error, though, to view the choice of policy as made in an international vacuum. Since the tax policy of foreign governments cannot be taken as a given, an analysis of the national interest that neglects their reactions is fundamentally flawed. Like free trade, capital-export neutrality has to be understood as an international discipline or standard that may leave all participants better off than they would be under likely noncooperative alternatives. That is, a policy of capital-export neutrality by all countries may lead to an outcome that is better for all than would obtain if policy were made separately on the a assumption of no foreign interactions.

Ault and Bradford, *op. cit.*, pp. 32-33. The practical limits to date on global welfare-maximizing, transnational coordination in the real world are of course abundantly in evidence. One example is the tendency of States and localities within the United States to compete with each other through tax incentives to induce inbound investment flow. Another example is the similar situation among the member nations of the European Communities. As recognized last year by the Commission of the European Communities, "[i]n almost all the Member States company taxation is used as a vehicle for incentives through which economic or structural policy objectives are pursued. . . . There is absolutely no intention of questioning the aim of these tax incentives, provided the Treaty obligations are observed." Guidelines on company taxation, 20 April 1990, SEC (90) 601 final.

[90] If capital income constitutes a larger share of upper-income household incomes, then relocation of investment abroad will also increase inequality across income classes.

[91] This point has been stressed by the Bush Administration, which has opposed restrictions on investment by foreigners in the United States:

> The unhindered flow of foreign direct investment leads to additional productive resources in the United States and facilitates the realization of cost efficient scales of business by consolidating under one corporate roof separate, but related, operations. These boost the productivity and international competitiveness of the United States, create jobs, and promote innovation and productivity. The inflow of capital helps to sustain U.S. investment despite the current low U.S. national saving rate, and thus contributes to economic growth.
>
> When U.S. multinational firms first set up in Europe during the 1950s and 1960s, many Europeans feared that Europe was being bought out by Americans and that their economies were being Americanized. U.S. direct investment has benefited the European economy. The recent increase in foreign direct investment in the United States will similarly benefit the U.S. economy.

Council of Economic Advisors, *Economic Report of the President*, Washington: U.S. Government Printing Office, 1991, p. 258.

U.S.-owned businesses located abroad may not be able to compete in overseas locations if they are subject to U.S. tax in addition to local tax.[92] Congress referred to such concerns in rejecting the President's proposal to eliminate all deferral in the Revenue Act of 1962.[93] Carried to its logical conclusion, however, a policy of capital import neutrality would relinquish to foreign governments control over the U.S. tax treatment of outbound investment by Americans. For example, if an industrialized country offers tax-sparing incentives for investment by its residents in a developing country, the United States would have to match those incentives in order to implement this policy.

Although it is not certain that labor income declines as a result of outbound investment (e.g., it will not decline if there is no reduction in investment in the United States), labor unions have been the leading proponents of national neutrality. Reducing the flow of capital from the United States to foreign countries could increase employment in the United States and the wages of U.S. workers. Labor unions in the early 1970s were the strongest supporters of the Burke-Hartke bills, which would have repealed the foreign tax credit and eliminated deferral.[94]

B. Deferral as a Departure from Capital Export Neutrality and as an Incentive for Outbound Investment

With regard to the relative tax treatment of domestic and outbound investment, many of current U.S. tax law provisions work at cross purposes. Some provisions favor outbound investment, while others discourage it. For example, the ability to "cross-credit" foreign taxes provides a tax incentive for U.S. multinational corporations with unused foreign tax credits to locate new investment in low-tax jurisdictions instead of the United States, since the effective rate of combined foreign and domestic tax on income from that new investment will be below the U.S. rate on income from new domestic investment. On the other hand, tax provisions purposely designed to increase various types of investment—namely, the research and experimental tax credit, rules allowing accelerated depreciation, various incentives applicable to the development and production of natural resources, and the investment tax credit (before it was repealed by the 1986 Tax Reform Act)—usually do

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[92] Arguments for capital import neutrality may be found in Norman B. Ture, "Taxing Foreign Source Income: The Economic and Equity Issues," New York: Tax Foundation, 1976; Arthur Young & Company, "The Competitive Burden: Tax Treatment of U.S. Multinationals," Tax Foundation Special Report, Washington D.C.: Tax Foundation, undated (circa. 1988); and William P. McLure and Herman B. Bouma, "The Taxation of Foreign Source Income From 1909 to 1989: How A Tilted Playing Field Developed," *Tax Notes*, June 12, 1989, pp. 1379-1410.

[93] "Testimony in hearings before [the House Committee on Ways and Means] suggested . . . that to impose the U.S. tax currently on the U.S. shareholders of American-owned businesses operating abroad would place such firms at a disadvantage with other firms located in the same areas not subject to U.S. tax." H.R. Rep. No. 1447, 87th Cong., 2d Sess. 57-58 (1962).

[94] See, for example, the statement of then AFL-CIO President George Meany:

> [T]hese provisions [i.e. deferral and the foreign tax credit] have also encouraged and subsidized the export of American jobs, technology, and production facilities. They have contributed substantially to the Nation's problems in international trade and investment, to inflation, raw materials shortages, and helped to undermine America's industrial base while making America increasingly vulnerable to economic blackmail.

Public Hearings Before the Committee on Way and Means on the Subject of Tax Reform, Part 1 of 5, 94th Cong., 1st Sess., July 8-11, 1975, p. 845.

not apply to investment located abroad. Given the apparently contradictory directions of these policies, no overall policy goal toward outbound investment is readily discernible.

Income from outbound investments earned by the separately incorporated foreign subsidiaries of U.S. corporations generally is not subject to tax until that income is repatriated. If for a particular taxpayer the effective rate of foreign tax can be expected to be consistently above the U.S. rate, this deferral of U.S. taxes would not provide any tax benefit. However, if the effective rate of foreign tax is at any time or in any jurisdiction below the U.S. rate, U.S. multinationals may enjoy two substantial benefits from deferral.

First, deferral may delay the payment of U.S. taxes on foreign source income until earnings are repatriated. When U.S. taxes are not paid as the income is earned, the taxpayer effectively is granted an interest free loan each year on tax that would have been due. The greater the excess of the U.S. over the foreign tax rate, and the longer the period of time between the time income is earned and the time of actual repatriation, the larger the benefit of deferral and the greater the incentive for outbound investment relative to domestic investment.[95] Therefore, the reduction of the top marginal corporate tax rates from 46 percent to 34 percent by the Tax Reform Act of 1986 substantially reduced the benefits of deferral since many countries—especially developed, industrialized countries—generally have effective rates in excess of 34 percent. Particular taxpayers or particular industries, however, may enjoy lower effective rates even in these high-tax countries, either through a tax incentive for a particular industry or through a "tax holiday" provided by a foreign government to induce foreign investment within its borders.

Under a regime of deferral, at the time of its choosing, the taxpayer repays these loans when he decides to repatriate earnings, and they become subject to tax. This is similar in many respects to the benefit enjoyed from delaying realizations of capital gains. As with capital gains, one method of eliminating the tax benefit of deferral is the payment of taxes on income as it is earned, rather than when payment is received. This is achieved, in limited circumstances, by the various anti-deferral regimes in the Code.

Second, because excess foreign tax credits cannot be carried forward indefinitely, deferral expands the opportunity for eliminating excess credits through the use of cross-crediting (if effective foreign tax rates vary across years or across jurisdictions). For example, a taxpayer would use its ability to defer repatriation of high-taxed income until the year when the U.S. taxpayer chooses also to repatriate low-taxed income.

A taxpayer may seek to increase the benefits of deferral by taking an aggressive position on transfer prices between itself and a foreign subsidiary to shift income away from current U.S. tax-

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[95] Some studies have demonstrated that, in theory, if foreign investment is financed out of retained earnings, then only the source country's tax rate affects the incentive to invest and the length of deferral does not affect the effective marginal tax rate. See, for example, David G. Hartman, "Tax Policy and Foreign Direct Investment in the United States," *National Tax Journal*, Vol. 37, 1984, pp. 475-87. In the Hartman framework, investment from retained earnings is tax-advantaged; however, this is inconsistent with the observed simultaneous repatriation and transfer of funds overseas by U.S. multinational businesses.

ation. Moreover, the benefit may be further enhanced if foreign government restrictions on transactions between related companies can be used to defend those positions.[96] Without deferral, on the other hand, transfer pricing issues may have little or no impact on the inclusion of income on the U.S. return. (They may still, however, have an impact on whether income is sourced as foreign or domestic.) Not only does the taxpayer's benefit in this case result in a loss of revenue to the government, but in addition, the government may suffer a further cost in sheer administrative effort required to dispute the taxpayer's transfer prices.[97]

Even assuming that the taxpayer and the IRS can work cooperatively, the legal issues involved are highly imprecise and subjective. Where a U.S. corporation sets up a manufacturing operation in a foreign subsidiary, for example, large amounts of tax liability may turn on whether the foreign subsidiary is or is not perceived to be legally at risk as to the volume of product it will be able to sell or the price at which it can be sold, as in the *Bausch & Lomb* case, described above. The question of which party bears the risk, in turn, is obscured by the very ownership of the foreign corporation by the U.S. corporation, resulting in what some may argue is a standard of quite elusive comprehensibility or enforceability.

On the other hand, deferral imposes costs on taxpayers, in addition to requiring them to bear their own share of the administrative burden of dealing with transfer pricing issues. For example, subpart F, and its interactions with the credit rules and the other anti-deferral rules, are considered highly complex.[98] In addition, the interest allocation rules, by precluding full worldwide fungibility of interest among commonly controlled domestic *and foreign* subsidiaries, may impose costs on a U.S. corporation that operates through foreign subsidiaries, which costs might be avoided by operating through foreign branches of a U.S. corporation.

To the extent that deferral provides an advantage to outbound investment as described above or otherwise,[99] this advantage provides an incentive for outbound investment and therefore moves the U.S. system of taxation of foreign income away from capital export neutrality. The subpart F rules partially offset this incentive, but were meant to serve primarily as revenue protection measures—like the foreign personal holding company rules—by preventing foreign operations from serving as potential shelters from U.S. taxation. It seems clear that the incentive effects of deferral on outbound investment were understood at the time sub-

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[96] See *Procter & Gamble v. Commissioner*, 95 T.C. 325 (1990).

[97] The difficulty of resolving such cases is exemplified by the recent case of *Sundstrand Corp. v. Commissioner* 96 T.C. 225 (1991). The record in that case disclosed that the taxpayer "from the beginning hampered respondent's attempts to determine the true taxable income of the related parties," thereby putting the IRS "at an extreme disadvantage." *Id.* at 374. Moreover, the court, like the IRS, was unable to accept the taxpayer's asserted transfer prices. Nevertheless (or perhaps because of this), the taxpayer was able to convince the court to reject the IRS reallocation of income on the grounds that IRS had acted arbitrarily, capriciously, and unreasonably in exercising its discretion to reallocate income under section 482. The court found it necessary to construct an appropriate arm's length transfer price on its own from the raw data provided by the parties.

[98] E.g., Tillinghast, "International Tax Simplification," 8 *Am. J. Tax Policy* 187, 190 (1990).

[99] For a more detailed discussion of the economic effects of deferral, see Gary Hufbauer and David Foster, "U.S. Taxation of the Undistributed Income of Controlled Foreign Corporations," in Department of the Treasury, *Essays in International Taxation: 1976.*

part F was enacted.[100] The proposed 1961 and enacted 1962 special exception to repeal of deferral for earnings from investments in less developed countries were expressly justified as means to increase the economic development of those countries through increased U.S. investment.[101]

C. Economic Evidence Relating to Outbound Investment and Tax Deferral

The effect of deferral on outbound investment

While it is not disputed that deferral can theoretically provide a tax incentive for outbound investment in low-tax jurisdictions, it is not known to what extent this incentive actually affects location of investment. The broader question of whether tax incentives affect investment generally is the subject of much dispute in the economics profession despite numerous studies conducted to settle this question.[102] On the more specific question of the effect of taxes on outbound investment, the limited economic evidence that does exist indicates that taxes do have an effect on the location of international investment.[103]

Intuitively, it seems clear that in many cases taxes cannot be the most important consideration in investment decisions. Other factors, such as wage rates, proximity to final markets, proximity to natural resources, transportation costs, regulatory climate, tariffs, and risk of expropriation also play important roles. Nevertheless, taxes could affect the location of investment in the case where an investor is otherwise relatively indifferent between the choice of two locations. If taxes do not affect investment location decisions, it can be argued that raising the effective rate of tax on outbound investment to that on domestic investment by repeal of deferral could have little economic impact beyond reducing profits of multi-

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[100] The Kennedy Administration's explanation of the proposed anti-deferral rules includes several references to their effect on the location of investment:

> Certainly since the postwar reconstruction of Europe and Japan has been completed, there are no longer any foreign policy reasons for providing tax incentives for foreign investment in economically advanced countries.
>
> . . . While the rate of expansion of some American business operations abroad may be reduced through the withdrawal of tax deferral such reduction would be consistent with the efficient distribution of capital resources in the world, our balance of payments needs, and fairness to competing firms located in their own country.
>
> . . . I recommend that tax deferral be continued for income from investment in developing economies. The free world has a strong obligation to assist in the development of these economies, and private investment has an important contribution to make. Continued tax deferral for these areas will be helpful in this respect. In addition, the proposed elimination of income tax deferral on U.S. earnings in industrialized countries should enhance the relative attraction of investment in less developed countries.

"The President's Tax Message," reprinted in Committee on Ways and Means, *Legislative History of H.R. 10650, The Revenue Act of 1962*, 90th Cong., 1st Sess. 147 (1967).

[101] The Tax Reform Act of 1976 repealed this exception for investment in less developed countries.

[102] See Dale W. Jorgenson, "Econometric Studies of Investment Behavior: A Survey," *Journal of Economic Literature*, Vol. 9, December, 1971, pp. 1111-47; and Robert Eisner, "Econometric Studies of Investment Behavior: A Comment," *Economic Inquiry*, Vol. 12, 1974, pp. 91-103.

[103] James R. Hines and Eric M. Rice in "Fiscal Paradise: Foreign Tax Havens and American Business," National Bureau of Economic Research Working Paper No. 3477 (October 1990) present some evidence that multinational corporations locate capital in low-tax jurisdictions. Michael J. Boskin, "Tax Policy and the International Location of Investment," in Martin J. Feldstein (ed.), *Taxes and Capital Formation*, Chicago, University of Chicago Press, 1987, p. 79 and David G. Hartman in "Domestic Tax Policy and Foreign Investment: Some Evidence," National Bureau of Economic Research Working Paper No. 784, (October 1981) present evidence that *domestic* taxation affects the level of outbound investment.

national corporations. On the other hand, under the above assumption any reduction of deferral would not provide any potential economic benefit to the United States (beyond an increase in U.S. tax receipts) since outbound investment would remain unchanged and there would be no potential offsetting increase in domestic capital formation.

The effect of outbound investment on domestic investment

Crowding out

To the extent that deferral does increase outbound investment, the effect of deferral on the economy will depend heavily on whether increased outbound investment reduces domestic investment. If sources of investment funds do not expand, any increase in outbound investment from deferral will "crowd out" domestic investment. This results in a smaller domestic capital stock, reduced productivity, and reduced employment in the domestic economy. Furthermore, since foreign jurisdictions generally tax direct investment at the source and the United States grants tax credits for these taxes, there will be a reduction of U.S. tax revenue. If, however, an increase in outbound investment does not "crowd out" domestic investment, there need not be any reduction in U.S. capital formation or employment. Furthermore, to the extent the U.S. tax rate exceeds the foreign tax rate, the United States may collect additional tax revenue.

Direct evidence on crowding out

Although knowledge of the effect of outbound investment on domestic investment is critical in determining whether incentives for outbound investment are detrimental to U.S. employment, there is scant empirical evidence available to directly address this question. One unpublished paper does lend some support to the view that outbound investment does reduce domestic investment.[104] If additional research were to yield similar results, the case that deferral is detrimental to U.S. interests would be substantially strengthened.

Indirect evidence from responsiveness of saving

Some indirect evidence on the effect of outbound investment on domestic investment might potentially be derived from studies of the responsiveness of saving to changes in the rate of return. If outbound investment does not reduce domestic investment, the source of funds for the overall increase in investment must arise either from increased domestic saving or from increased investment by foreigners in the United States. The evidence on the responsiveness of saving to changes in the rate of return is to date, however, inconclusive.[105] If increased domestic saving matches any

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[104] Guy V.G. Stevens and Robert E. Lipsey, "Interactions Between Domestic and Foreign Investment," International Finance Discussion Paper No. 329, Board of Governors of the Federal Reserve System, August 1988.

[105] Substantial disagreement exists among economists as to whether taxpayers will respond to increases in net return on savings by increasing or reducing their saving. Some studies have argued that theoretically one should expect substantial increases in saving from increases in the net return. Other studies have argued that, theoretically, large behavioral responses to changes

Continued

increase in outbound investment in response to the increase in the after-tax rate of return available on foreign investment as a result of tax incentives for outbound investment, deferral need not have a detrimental effect on U.S. employment. On the other hand, if domestic saving is not responsive to the increase in the after-tax rate of return on outbound investment, domestic capital formation and domestic employment will suffer, unless the reduction in domestic investment by U.S. multinational corporations is offset by increases in inbound investment of foreign multinational corporations in the United States.

The effect of outbound investment on exports

As shown in the data presented above in Table 1 of Part II, although the trade activities of U.S. multinational corporations in several developing countries with low tax rates are in deficit to the United States, foreign affiliates of U.S. multinationals in aggregate purchase more from the United States than they sell to the United States. Economic research has not found any negative impact of increased foreign investment on exports by U.S. multinational corporations. In fact, to the extent there is any impact at all, increased foreign affiliate production tends to increase exports by U.S. parents to their foreign affiliates.[106]

These results do not necessarily provide evidence, however, that the existence of foreign affiliates improves the overall U.S. trade balance. It could be that increased production by foreign affiliates crowds out exports by purely domestic firms. If this were the case, a reduction in activities of foreign affiliates could result in greater value-added within U.S. borders and the value of exports would increase. In this case, the trade of foreign affiliates with their U.S. parents might represent a net surplus for the United States but outbound investment still might reduce domestic employment.

The effect of outbound investment on domestic employment

Since the trade between a U.S. parent and its affiliates might favorably contribute to the overall U.S. balance while at the same time foreign activities of U.S. multinationals reduces domestic production, the critical question remains whether outbound investment reduces domestic employment. There are unfortunately few economic studies addressing this issue. One relatively recent paper examines the effect of outbound investment on domestic employment, and finds some evidence that increases in overseas activities by U.S. multinational corporations reduce their domestic employment.[107] To the extent that this relationship exists, however, the

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in the after-tax rate of return need not occur. Empirical investigation of the responsiveness of personal saving to after-tax returns provides no conclusive results. Some studies find personal saving responds strongly to increase in the net return, while others find little or a negative response. For a discussion of the determinants of the rate of saving, see Joint Committee on Taxation, *Present Law, Proposals, and Issues Relating to Individual Retirement Arrangements and Other Savings Incentives* (JCS-11-90), March 26, 1990; and Joint Committee on Taxation, *Description and Analysis of S. 612 (Savings and Investment Incentive Act of 1991)* (JCS-5-91) May 14, 1991.

[106] Irving B. Kravis and Robert E. Lipsey, "The Effect of Multinational Firms' Foreign Operations on their Domestic Employment," National Bureau of Economic Research Working Paper No. 2760; and Magnus Blostrom, Robert E. Lipsey, and Ksenis Kulchycky, "U.S. and Swedish Direct Investment and Exports," in Robert E. Baldwin, ed. *Trade Policy Issues and Empirical Analysis*, Chicago: University of Chicago Press, 1988.

[107] Irving B. Kravis and Robert E. Lipsey, *op. cit.*

authors attribute it largely to the allocation of more labor intensive activities abroad and more skill- and capital-intensive activities to the United States. Therefore, although multinational corporations may have fewer domestic employees as a result of their overseas production, they also provide greater compensation per domestic employee as a result of their overseas production.

D. Other Issues Related to the Proposal

Legislation repeals deferral only for imported property income

The case is often argued that deferral in general should not be limited since foreign subsidiaries of U.S. multinational corporations increase U.S. exports by purchasing from the United States inputs in the production of goods for final sale in foreign markets. Legislation to limit deferral in the manner provided in H.R. 2889, by targeting the limitation to income derived from imports and leaving income from sales to non-U.S. markets unaffected, largely avoids this criticism. If a foreign affiliate of a U.S. multinational corporation does not import goods to the United States and only produces goods for foreign markets, the income of the affiliate is not affected by the proposal. However, it may be argued that it is not in the interest of the United States to impose tax greater than the rate of foreign tax on an affiliate which on net improves the U.S. trade balance just because it sells some foreign-produced goods in U.S. markets.

Legislation offsets only tax advantages

H.R. 2889 is not designed to affect production located overseas by U.S. multinationals that take advantage of non-tax factors, such as lower wage rates. For example, a U.S. multinational corporation may locate production in a foreign country because wage rates are a fraction of U.S. rates, or because the country's government has provided certain non-tax subsidies to locate production there. If this affiliate paid foreign tax comparable to, or greater than, that which would be paid in the United States, the inability to defer U.S. tax on its income need not result in any significant U.S. tax cost in the current year, with respect to its imported property income. In fact, under the bill, high taxes on such income will continue to the eligible for cross-crediting against income of related controlled foreign corporations that are earning imported property income subject to low foreign taxes. On the other hand, the taxpayer with high-taxed imported property income loses, under the bill, the opportunity to average those taxes with low-taxed foreign income outside the separate "imported property" foreign tax credit limitation basket. The proposal also would tend to trigger tax increases on U.S. multinational corporations when they produce goods in low-tax jurisdictions and those goods are destined for the U.S. market (subject to the averaging opportunities mentioned above that remain available under the bill). The tax that the proposal triggers does not go so far as to neutralize any non-tax factor that may have attracted U.S. investors to invest in a foreign location.

The amount of imports from foreign affiliates in low-tax countries

As discussed earlier, the Tax Reform Act of 1986 substantially reduced statutory corporate tax rates and the benefit of deferral. Since many foreign countries now have effective corporate rates in excess of, or comparable to, U.S. rates, and the bulk of imports into the United States are from such countries, the proposal would have minimal impact on income from imports from many countries—theoretically, no residual U.S. tax would be paid on such income even if it *were* currently taxable. However, although it is only a relatively small percentage of total imports, a considerably large absolute amount of imports from foreign affiliates located in low-tax jurisdictions could be significantly affected. The data presented above in Table 1 of Part II can provide a rough measure of the impact of the proposal. In that data, 16 countries out of a total of 38 have average effective corporate income taxes rates of less than 25 percent. These countries accounted for $9.3 billion of imports by U.S. multinational corporations, which is 11 percent of the total of $87 billion.

Impact on different types of competitors

As noted earlier, a chief argument in favor of the proposal is that, to the extent foreign affiliates of U.S. firms produce for the U.S. market, their taxes would be raised to levels comparable to U.S. producers with whom they compete in the U.S. market. However, the proposal might be faulted for having a potential to raise taxes even on some foreign affiliates which, on net, buy more from the United States than they sell to the United States. In addition, the proposal is criticized by some for raising taxes on foreign affiliates that sell their goods in the United States when they must compete with low-taxed, foreign-owned foreign corporations that also compete in the United States. Third, assume that a taxpayer pays high foreign taxes on imported property income, which under current law it cross-credits against low-taxed, non-imported property foreign source income. In the absence of additional amendments which would separate high- and low-taxed imported property income, the bill could be criticized as inducing the taxpayer to shift some of its production for the U.S. market to a low-taxed foreign country in order to regain the benefits of cross-crediting.[108] Further, opponents of H.R. 2889 may complain that, without deferral on income, the measurement of income under U.S. tax law is unfairly biased *against* those earning foreign source income, for example by providing more favorable depreciation rates on domestic property than on foreign property.

On the other hand, the proposal may be faulted by others for not going far enough and eliminating tax benefits provided to U.S. affiliates when these affiliates (employing foreign workers) compete with domestic producers (employing U.S. workers) paying relatively high tax and competing in foreign markets with foreign companies. However, it should be noted that other aspects of U.S. tax law provide reductions in U.S. tax on income from U.S. exports. These in-

[108] This is a criticism that could have been addressed to most of the foreign tax credit limitation tighteners enacted recently.

clude the FSC rules and the "title passage" rule for sourcing inventory sales income.

Administrability of the proposal

Administering special rules for income attributable to goods produced for the U.S. market under H.R. 2889 raises issues inherent in determining whether the ultimate destination of goods is or is not reasonably expected to be the United States. This problem could be especially difficult in those cases where goods are sold to unrelated persons and in cases where goods sold become components in other goods, the expected destination of which also becomes a relevant issue. Opponents of H.R. 2889 may argue that the proposal introduces significant subjectivity, inefficiency, and uncertainty in the administration of the tax laws, or is only marginally enforceable.

The issue of determining the expected destination of goods under H.R. 2889 is not without its analogues in other parts of the tax code. The tax law also contains benefits for taxpayers that turn on the destination of goods, such as the Foreign Sales Corporation rules and an exception from treatment as subpart F base company sales income. In addition, issues of the destination of goods are not unknown to other areas of law, such as the export control laws. Proponents of the proposal argue that the existence of these destination standards indicates that the U.S.-destination test in H.R. 2889 would be administrable. The destination test in H.R. 2889—which turns on whether it is "reasonable to expect" that property would be either imported into the United States or used as a component in other property which would be imported into the United States—is based in part on those existing tax-law standards, but is perhaps an easier standard for taxpayers to know whether or not they have met.[109] Further, proponents argue that, although rigid accuracy in specifying the destination of goods might well place undue administrative burdens on the IRS and taxpayers, the statute allows the IRS to craft a flexible interpretation of the concept of reasonable expectation, the application of which can be both objective and fair. Opponents could argue, on the other hand, that even if the destination test under H.R. 2889 requires less certainty as to the actual destination of goods than some existing standards, it is also more prone to taxpayer manipulation, and in theory is a less easy standard for the IRS to administer, since it turns on expectations as well as actual events.

Impact on U.S. fisc

As noted above, advocates of the proposal contend that it will encourage investment in the United States by multinationals already headquartered here, causing increases in U.S. economic activity and tax receipts. On the other hand, opponents predict that other nations may retaliate by curtailing deferral granted to foreign-controlled corporations operating in the United States, thus discouraging foreign investment from locating here. In addition, it has been suggested that foreign nations with relatively low tax rates may

[109] Cf. Treas. Reg. secs. 1.927(a)-1T(d) and 1.954-3(a)(3).

raise those rates so that the U.S. fisc does not get full benefit from the imposition of current taxation. However, the willingness of other nations to retaliate in either of these ways may be tempered by a reluctance to single out U.S. operations or firms for unique treatment as compared to third-country operations or firms. Moreover, if retaliation by another nation does take the form of a fundamental revision of its internal tax policy, such a revision might include, for example, repeal of tax-based investment incentives, which would have generally favorable consequences for investment in the United States.

Opponents also argue that the U.S. fisc may be frustrated in its attempt to collect taxes on this imported income because such income may be shifted in ways that take advantage of remaining tax benefits, such as those available under section 936 of the Internal Revenue Code. On the other hand, this suggests that the proposal would increase the utilization of section 936 and other remaining tax incentives, a development which would be viewed favorably by some analysts.

Income from the importation of services

In its application only to imported *property,* H.R. 2889 does not address any tax issues arising from the "importation" of services from controlled foreign corporations. For example, it might be possible that a domestic corporation operating a U.S. business could establish a subsidiary in a low-tax country to provide services back to domestic persons (related or unrelated) in exchange for payments that the domestic persons would deduct against their U.S. taxes. If payments by the domestic persons were to exceed the costs incurred by the foreign subsidiary, the profits of the foreign subsidiary could be eligible for deferral, both under current law and under the Code as H.R. 2889 would amend it.[110] It may be argued that the same analysis applicable to deferral on imported property income should be applied to deferral on imported services income. Thus, were it thought desirable to enact H.R. 2889, consideration could also be given to treating services in a manner similar to that in which property is treated under the bill. On the other hand, at least in cases where services performed in a U.S.-owned foreign operation are all provided to related U.S. taxpayers, and no profits of the related U.S. taxpayers are shifted to a foreign tax jurisdiction (for example, because the foreign operation takes the form of a branch of a U.S. taxpayer), it may be that such "importation" of foreign-performed services does not directly affect U.S. corporate tax liabilities.

E. Election to Treat Controlled Foreign Corporations as Domestic

By comparing the rationale of the Kennedy Administration for repealing deferral generally, and the rationale of the Nixon Administration for repealing deferral on "runaway plants" only, one can infer that both proposals were intended to achieve the same

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[110] Since 1962, one notable exception to deferral for income from services provided to U.S. persons has been the treatment of insurance income as subpart F income where the insurance covered a U.S. risk. In 1986, the exceptions for deferral on services income were expanded to cover income from insurance more generally, and income from banking, and other financial services that takes the form of interest, dividends, and some gains.

general objective: effectively changing the overall (domestic plus foreign) tax burden only with respect to items of income that are, because of the confluence of U.S. and foreign tax subsidies, subject to abnormally low overall taxation. U.S. tax deferral would likely be of no moment to most taxpayers with substantial foreign operations in foreign countries imposing tax comparable to, or greater than, the U.S. rate, if two assumptions are made: (1) that there is a way to measure the share of a taxpayer's net income from domestic sources relative to its share of net income from foreign sources, which method could be widely agreed to among taxpayers and governments, and (2) that averaging of foreign tax credits is permitted as under the Code's current overall foreign tax credit limitation.

Proposals such as the Nixon Administration proposal or H.R. 2889 address this problem in part. However, significantly in the post-1986 world, these proposals do not relieve taxpayers of the disadvantage of applying asset-based, domestic-only affiliated-group-wide interest expense allocation rules to income attributable to commonly controlled corporations, both domestic and foreign. This disadvantage would be eliminated if the commonly controlled businesses were all held in corporations treated as domestic for U.S. tax purposes.[111]

The current system of partial deferral, then, imposes both benefits (deferral) and burdens (potentially excessive allocation of interest to that portion of foreign source income that the taxpayer chooses to repatriate) on taxpayers that could be eliminated, in a manner consistent with the purposes of H.R. 2889, if all controlled foreign corporations were simply treated as domestic. Taxpayers that on average pay substantial effective rates of foreign tax would actually be advantaged relative to current law, and those that do not pay substantial effective rates of foreign tax would in some cases be treated at least as well or better than under H.R. 2889.

Beyond the issue of interest expense allocation, there are other factors suggesting that the taxpayer which is not disproportionately motivated by tax considerations in its foreign investment location decisions would be benefited by treating its foreign subsidiaries as though they were domestic for U.S. tax purposes. Computation of the foreign tax credit and the foreign tax credit limitation for a U.S. corporation carrying on all of its foreign operations through *branches* requires application of detailed statutory and regulatory rules for the sourcing of items of income to either foreign or domestic sources, the allocation and apportionment of deductions between domestic and foreign source gross income, and the further division of foreign source income and foreign taxes among the various foreign tax credit limitation categories or "baskets." Application of those rules to a U.S. corporation carrying on foreign operations through foreign corporate *subsidiaries*, however, is complicated by a number of factors, including the need to compute the portion of foreign taxes paid by a foreign subsidiary that are "deemed paid" by the U.S. corporation; the need to allocate

[111] It has been argued that bringing foreign corporations into the affiliated group solely for interest allocation purposes but not for current tax liability purposes is flawed in a way analogous to allowing the expenses of producing income that is currently tax-exempt to offset tax on income that is currently taxable.

items of expense among the items of income attributable to the domestic and foreign corporations; the need to apply the anti-deferral and branch tax rules to income of the foreign corporations; and the interaction of the foreign tax credit rules with the anti-deferral rules. Allocation of income between related domestic and foreign corporations through the setting of intra-group transfer prices also gives rise to legal and factual concerns apart from application of the foreign tax credit rules. Operating through a foreign corporation denies the multinational an ability to offset U.S. tax on U.S. income by deducting foreign losses; operating through a foreign branch of a U.S. corporation may permit losses to be used.

If a U.S. corporation or other U.S. person finds it practical to choose to conduct its foreign operations through a U.S. corporation, or conducts foreign operations through a foreign corporation that qualifies for elective U.S. corporation treatment under the special rules for insurance companies or contiguous country corporations, the U.S. person may be spared the issues arising under the anti-deferral and transfer pricing rules and the interactions of the rules applicable to controlled foreign corporations with those governing foreign tax credits. In that case, moreover, losses from foreign operations, may be deducted from U.S. income. Thus, if a particular U.S. taxpayer faces foreign and domestic tax rates that are on average comparable, then the performance of foreign operations through domestic corporations would appear to offer taxpayers some significant advantages.

Given, then, that absence of deferral in some cases may serve the interests of both taxpayers and tax policy, it may be argued that the Code ought to provide an opportunity to waive deferral. Assuming H.R. 2889 were enacted, elective treatment of U.S.-controlled foreign corporations as domestic could provide taxpayers an attractive alternative to the application of the H.R. 2889 rules.

If such an election were permitted, a number of issues in the design of the election would arise. Opportunities to choose at will the domestic or foreign tax status of each foreign corporation within a single controlled group may undercut some of the policy objectives of deferral waiver. Among other things, election on a company-by-company basis might reintroduce some of the planning opportunities similar to those sought to be repealed with the advent of the "one-taxpayer" rules for interest expense allocation in 1986.

If some sort of consistency requirement were to be imposed, then, an initial issue would be the scope of the consistency requirement triggered by an election with respect to any particular foreign corporation. If the foreign corporation is a controlled foreign corporation more than 50 percent of the vote or value of the stock of which is owned by a single U.S. shareholder or by multiple members of a group of related U.S. taxpayers, then consistency might require, for example, the election to extend to all controlled foreign corporations more than 50-percent owned directly or indirectly by members of that group.[112] On the other hand, it may be argued that

[112] It might or might not also be deemed appropriate to permit a company other than a controlled foreign corporation to elect domestic corporate status.

particular corporations ought not to be subject to the consistency regime. For example, it may be thought that foreign members of the electing group that are Foreign Sales Corporations (FSCs) ought to be permitted to retain deferral on the portion of their income that is not already currently taxable by the United States, at least as long as waiver of deferral is not mandatory, and the FSC is engaged in only those activities that were intended to be benefited by the FSC regime. As another example, assume that there are two groups described as above with a common foreign parent. There logically might be a rule requiring both groups to elect, or fail to elect, consistently.

Once an election is made, the question would arise as to when it can be rescinded as to any particular foreign corporation. In some aspects this is not unlike the question whether an election for a particular controlled foreign corporation should trigger an election with respect to any other foreign corporation—if it is desirable to prevent an inconsistent election ab initio, it would appear to be inappropriate to permit exactly the same result through an initial group-wide election, followed by a selective rescission. Another issue is how to deal with operational changes in the controlled group once the election has been made. For example, changes in control of one or more members of the group or one or more of the affected controlled foreign corporations might be a logical occasion for reexamining the election.

Similarly, the question would arise as to when an election can be rescinded as to the entire group. One possible response to such a rescission would be to apply a rule similar to that of section 1504(a)(3), under which an affiliated group that elects to cease filing a consolidated income tax return cannot elect to begin filing consolidated returns again for 5 years.

Presumably, a foreign corporation to which domestic treatment applies would be treated as transferring all of its assets to a domestic corporation in an exchange to which section 354 applies (cf. Treas. Reg. sec. 7.367(b)-7(c)(2)).[113] However, an issue would arise in the case of a foreign corporation which, if domestic, would qualify for treatment under the insurance company tax rules of part I or II of subchapter L. The tax consequences of this deemed transfer could continue to be governed by the existing provisions of section 953(d). Under those provisions, special rules apply to pre-1988 earnings and profits, and an additional tax (up to $1,500,000) is imposed based on capital and accumulated surplus as of December 31, 1987.

A foreign corporation that ceases to be subject to the election would presumably be treated as a domestic corporation transferring all of its property to a foreign corporation in an exchange to which section 354 applies.

A foreign corporation subject to an election might generally be treated as a domestic corporation for all purposes of the Code. Thus, for example, such a corporation could be treated as other than a foreign corporation for purposes of section 1503(d)(2)(B), which provides that to the extent provided under regulations, the

[113] And presumably net operating losses or built-in losses of the corporation deemed to be making the transfer would not be usable by the corporation deemed to be acquiring the transferred assets (cf. Rev. Rul. 72-421, 1972-2 C.B. 166).

term "dual consolidated loss" will not include any loss which, under foreign income tax law, does not offset the income of any foreign corporation. Current regulations implementing this authority are found in Treas. Reg. sec. 1.1503-2T(c).

For example, assume that an election applies for a taxable year to one or more foreign corporations that, by reason of the election, are members of an affiliated group of actual and deemed domestic corporations filing a consolidated U.S. tax return. Assume that the only members of the affiliated group that generate positive taxable income for the taxable year are among these foreign corporations. Also assume that a dual resident corporation belonging to that group incurs a loss for the taxable year. For purposes of this example, the dual resident corporation could either be a foreign corporation subject to the election or a corporation organized under U.S. law but resident in a foreign country for foreign tax purposes. Assume that under foreign law every other foreign corporation the income of which could be offset by the loss is and must, by virtue of a consistency rule, also be subject to the election. In that case, the loss could be treated as one that offsets the income of other "domestic corporations." Therefore, the Secretary could be authorized to permit such a loss to offset the income of any corporation in the affiliated group, assuming such treatment was otherwise appropriate taking into account all other relevant factors.

Of course, the issues that would arise in the design of an election are to some extent interdependent. For example, the stricter the rule of consistency, the less justification there would be to deny deductions under the dual consolidated loss rules. As another example, if all other things remain equal, the tighter the gain recognition rules on deemed inbound and outbound transfers, the more readily could revocations of prior elections be permitted.

APPENDIX:

Explanatory Notes to Table 1

The following are explantory notes relating to Table 1 (in Part II):

(1) The first four data columns are from U.S. Department of Commerce, Bureau of Economic Analysis, *U.S. Direct Investment Abroad, Operations of U.S. Parent Companies and their Affiliates, Revised 1988 Estimates*, July 1991 (referred to here as the "1988 Commerce Estimates"). The information is from data for nonbank foreign affiliates of nonbank U.S. parents. The data include both majority-owned and minority-owned affiliates. A foreign affiliate must have a U.S. parent that owns or controls, directly or indirectly, at least 10 percent of the affiliate.

(2) U.S. merchandise exports shipped to affiliates are from Table 16 of the 1988 Commerce Estimates. They include goods shipped by U.S. parents as well as goods shipped by unaffiliated U.S. persons to foreign affiliates.

(3) U.S. merchandise imports shipped from affiliates are from Table 17 of the 1988 Commerce Estimates. They include goods shipped to U.S. parents as well as goods shipped to unaffiliated U.S. persons from foreign affiliates.

(4) Average employee compensation is the employee compensation of affiliates (Table 13 of the 1988 Commerce Estimates) divided by employment of affiliates (Table 11 of the 1988 Commerce Estimates).

(5) Return on assets is net income of affiliates (Table 9 of the 1988 Commerce Estimates) divided by total assets of affiliates (Table 3 of the 1988 Commerce Estimates).

(6) Effective tax rates are calculated as the ratio of foreign income taxes paid divided by earnings and profits before taxes from revised, unpublished 1986 data provided by the Foreign Returns Analysis Section of the Statistics of Income Division of the IRS. These data are generally described by Margaret P. Lewis, "Controlled Foreign Corporations, 1986," *Statistics of Income Bulletin*, Summer 1991, pp. 29-50. These statistics are derived from the 7,500 controlled foreign corporations which were the largest in terms of total assets. Unlike the Commerce Department data which is classified by location of physical assets and location of business activity, the tax return data are classified according to country in which the controlled foreign corporation was incorporated. Some of the taxes paid and some of the earnings and profits may have arisen in countries other than the country in which the controlled foreign corporation was incorporated.

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